Supreme Court, U.S.
FILED
071526 JUN 6 - 2008
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No. 07- (1)

In the Supreme Court of the United States

CEMCO INVESTORS, LLC, AND
FOREST CHARTERED HOLDINGS LTD.,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

PETITION FOR A WRIT OF CERTIORARI

THOMAS D. SYKES
McDERMOTT WILL & EMERY LLP
227 W. Monroe St., 56th Floor
Chicago, Illinois 60606
(312) 372-2000

M. MILLER BAKER
Counsel of Record
PAUL M. THOMPSON
JEFFREY W. MIKONI
McDERMOTT WILL & EMERY LLP
600 Thirteenth St., N.W.
Washington, D.C. 20005
(202) 756-8000

Attorneys for Petitioners
(Additional counsel listed on inside cover)

June 6, 2008

Additional Counsel for Petitioners:

RORY K. LITTLE
HASTINGS COLLEGE OF
LAW (U.C.)
200 McAllister St.
San Francisco, CA 94102
(415) 565-4669

QUESTIONS PRESENTED

In 2003, the IRS promulgated a new temporary regulation, which changed the rules governing the claiming of taxable losses based on the sale of property held by a partnership. The IRS relied upon this regulation to retroactively invalidate a deduction claimed by the petitioners in 2000, and then imposed a 40% "valuation-misstatement" penalty against the petitioners for claiming the deduction. The Seventh Circuit affirmed the retroactive application of the regulation based on its determination that the transaction was invalid under the "economic substance" doctrine, and affirmed the imposition of the 40% penalty without discussion.

The questions presented are:

1. Whether the Seventh Circuit erred when it concluded, in conflict with the tests applied in the Third, Fourth, Ninth, Tenth, and D.C. Circuits, that a transaction violated the economic substance doctrine without giving any consideration to the pre-tax profit potential of the transaction or the business purposes underlying it.

2. Whether the Seventh Circuit erred when it affirmed, in conflict with the rule followed in the Fifth and Ninth Circuits, the imposition of a valuation-misstatement penalty under 26 U.S.C. § 6662 for a deduction wholly disallowed on purely legal grounds involving no dispute over valuation.

PARTIES TO THE PROCEEDING

The parties to this proceeding are the same as those in the proceedings below: Cemco Investors, LLC; Forest Chartered Holdings Ltd.; and the United States of America.

RULE 29.6 STATEMENT

Neither Cemco Investors, LLC, nor Forest Chartered Holdings Ltd. has any parent corporations, nor does any publicly-held company own 10% or more of either party's stock.

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2. Whether the Seventh Circuit erred when it affirmed, in conflict with the rule followed in the Fifth and Ninth Circuits, the imposition of a valuation-misstatement penalty under 26 U.S.C. § 6662 for a deduction wholly disallowed on purely legal grounds involving no dispute over valuation.

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PETITION FOR A WRIT OF CERTIORARI

Cemco Investors, LLC, and its tax matters partner, Forest Chartered Holdings Ltd.,[1] respectfully petition this Court for a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case.

OPINIONS BELOW

The decision of the court of appeals is reported at *Cemco Investors, LLC v. United States*, 515 F.3d 749 (7th Cir. 2008), and is reprinted at App. 1–10.

The court of appeals affirmed the decision of the United States District Court for the Northern District of Illinois, which is unofficially reported at *Cemco Investors, LLC v. United States*, No. 04C8211, 2007 U.S. Dist. LEXIS 22246 (N.D. Ill. Mar. 27, 2007), and reprinted at App. 11–35.

JURISDICTIONAL STATEMENT

The United States Court of Appeals for the Seventh Circuit entered its judgment and opinion on February 7, 2008. Petitioner's application to extend the time to file a petition for writ of certiorari until June 6, 2008, was granted by Justice Stevens on April 4, 2008. Supreme Court Dkt. No. 07A812. This Court has jurisdiction over this matter pursuant to 28 U.S.C. § 1254(1).

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[1] For convenience, Cemco Investors, LLC, and Forest Chartered Holdings Ltd. are collectively referred to throughout this petition as "petitioner" or "Cemco."

STATUTES AND REGULATIONS

26 U.S.C. § 6662(a) provides:

> **Imposition of penalty.**
>
> If this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies.

26 U.S.C. § 6662(b) provides in pertinent part:

> **Portion of underpayment to which section applies.**
>
> This section shall apply to the portion of any underpayment which is attributable to 1 or more of the following:
>
> * * *
>
> (3) Any substantial valuation misstatement under chapter 1.

26 U.S.C. § 6662(e) provides in pertinent part:

> **Substantial valuation misstatement under chapter 1**
>
> (1) In general.
>
> For purposes of this section, there is a substantial valuation misstatement under chapter 1 if—

> (A) the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter 1 is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be)[.]

26 U.S.C. § 6662(h) provides, in pertinent part:

> **Increase in penalty in case of gross valuation misstatements**
>
> (1) In general.
>
> To the extent that a portion of the underpayment to which this section applies is attributable to one or more gross valuation misstatements, subsection (a) shall be applied with respect to such portion by substituting '40 percent' for '20 percent'.
>
> (2) Gross valuation misstatements.
>
> The term 'gross valuation misstatements' means—
>
> > (A) any substantial valuation misstatement under chapter 1 as determined under subsection (e) by substituting—
> >
> > > (i) in paragraph (1)(A), "200 percent" for "150 percent"[.]

The entirety of § 6662, along with additional relevant sections of the Internal Revenue Code of 1986, 26 U.S.C. § 752, and Treasury Regulation § 1.752–6, 26 C.F.R. § 1.752–6, are reproduced at App. 36–49.

STATEMENT OF THE CASE

1. The instant dispute arose out of the tax treatment of a series of transactions between Cemco and three other entities: Cemco Investors Trust ("the Trust"), Cemco Investment Partners ("the Partnership"), and Deutsche Bank ("the Bank"). In brief, a series of foreign currency options were purchased from an independent third party (the Bank), creating two possibilities of a future payoff on a $36,000 investment depending upon future fluctuations in the value of the euro against the dollar: (1) a payoff of $72,000, and (2) a payoff, although less likely, of $7.2 million. When Cemco filed its 2000 tax return in September 2001, it reported a loss of over $3.5 million, resulting from its sale of euros received through these transactions.

Cemco's deduction was justified by the then-prevailing interpretation of 26 U.S.C. § 752. App. 19. In *Helmer v. Comm'r*, 34 T.C.M. 727 (1975), the IRS urged (and the Tax Court agreed) that potential liabilities under a short option contract were *not* to be taken into account in determining a partnership's basis in those assets. The necessary consequence of the *Helmer* rule was such that, when the euros were transferred to Cemco, their basis included the $3.6 million spent to purchase the long option, but *not* the liabilities associated with the related short option.

As the district court appropriately acknowledged, this interpretation had long served as the correct understanding of the tax code. App. 19 ("Until recently, the law respecting whether an option contract should be treated as a liability under section 752 actually supported [Cemco's] position."). Accordingly, when Cemco ultimately sold the contributed euros it incurred a tax loss of nearly $3.6 million, and thus reported this loss on its 2000 tax returns.

2. In 2003, long after the execution and reporting of the transactions described above, the IRS promulgated a temporary version of a new Treasury Regulation § 1.752–6 (26 C.F.R. § 1.752–6).[2] This new regulation changed the law by reversing *Helmer*'s rule forbidding consideration of potential liabilities; taxpayers now had to include such liabilities when calculating the proper basis of those assets.[3] As a result, if the IRS applied this new rule to the options and obligations of the Partnership, the euros ultimately transferred to Cemco would have a reduced basis, and thus Cemco would have incurred a smaller taxable loss.

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[2] The regulation was not adopted in final form until nearly two years later. *See* 70 Fed. Reg. 30334 (May 26, 2005).

[3] Though the IRS suggested retreat from its endorsement of the *Helmer* rule prior to 2003, *see* IRS Notice 2000-44, 2000-2 C.B. 255 (Sept. 5, 2000), in internal deliberations the IRS's Chief Counsel previously suggested that *Helmer*'s interpretation of 26 U.S.C. § 752 was preferable and, in any event, could only be overruled by statute or regulation. *See* C.A. Appellants' Br. at 35 (and sources cited therein).

With this new provisional rule in place, the IRS turned to Cemco. Claiming that the new regulation had retroactive effect, the IRS disallowed Cemco's claimed loss deduction from the sale of the euros received by contribution from the partners of the Partnership, and adjusted Cemco's tax return accordingly. App. 16–17.

3. In addition to disallowing Cemco's deduction, the IRS asserted that Cemco's reporting of the transaction triggered a valuation-misstatement penalty under 26 U.S.C. § 6662. Under that section, the IRS may impose accuracy-related penalties against taxpayers whose underpayments are "attributable to . . . any substantial valuation misstatement." 26 U.S.C. § 6662(b)(3).

Congress first adopted the valuation-misstatement penalty system in 1981, in response to concern that the then-existing general underpayment penalty system did not adequately deter taxpayers from intentionally misstating the value of their assets. *See* U.S. House of Representatives Committee on Ways & Means, Report on H.R. 4242, H.R. Doc. No. 97-201, at 243 (1981). Under the old system, because "valuation issues frequently involve[d] difficult questions of fact," disputes were often resolved by "'dividing the difference' in the values asserted by the Internal Revenue Service and those claimed by the taxpayer." *Id.* This system encouraged taxpayers to intentionally overvalue certain types of property, with the expectation that difficult factual issues, a lax dispute resolution system, and a low underpayment interest rate would let them reap a benefit from the overvaluation. *Id.*

Accordingly, "a specific penalty [was] needed to deal with various problems related to valuation of property." *Id.*

To combat these abuses, modern § 6662 penalizes taxpayers who underpay their tax liability due to a "substantial valuation misstatement"; *i.e.*, if the value of any property claimed on their tax return exceeds that property's actual value by more than 150%. 26 U.S.C. § 6662(e)(1)(A). Taxpayers who commit substantial valuation misstatements are assessed an accuracy-related penalty in the amount of 20% of the resulting underpayment. 26 U.S.C. § 6662(a). Section 6662 further provides for the imposition of increased penalties for "gross valuation misstatements" in response to more extreme underpayments. 26 U.S.C. § 6662(h). In such cases, where the claimed value of property exceeds the actual value by over 200%, the valuation-misstatement penalty is increased to 40% of the amount of the resulting underpayment. 26 U.S.C. § 6662(h)(1)–(2).[4]

In this case, the IRS determined that Cemco had committed a "gross valuation misstatement," and therefore imposed a 40% penalty against it.

4. In December of 2004, Cemco challenged the IRS's actions by filing a petition for readjustment in

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[4] At the time the adjustments at issue in this case were made, the respective thresholds for "substantial" and "gross" valuation misstatements were 200% and 400%, respectively. However, the recent amendment lowering these thresholds does not impact any issues raised by this petition.

the Northern District of Illinois. Before the district court, both Cemco and the IRS filed cross-motions for summary judgment.

Cemco opposed the IRS's adjustment and penalty for, *inter alia*, two principal reasons. *First*, Cemco argued that because the IRS had made no effort to adjust the tax returns filed by the Partnership, the IRS could not adjust the derivative basis upon which Cemco relied for its reported loss. App. 24–27. Under 26 U.S.C. §§ 723 and 732, Cemco was obligated to treat the euros as having the same basis as that reported by their former owners, the Partnership's partners. As a result, Cemco argued, the IRS's decision not to adjust the Partnership's returns prevented it (and the court) from independently adjusting Cemco's loss deduction.

Second, Cemco argued that even if the IRS properly denied the deduction, it could not subject Cemco to a valuation-misstatement penalty under § 6662. App. 32–33. Cemco had accurately reported the basis of the euros and options based on the then-prevailing law, and had not made any misstatement of value (either direct or indirect). As a result, Cemco argued, the IRS could not legitimately apply the "valuation-misstatement" penalty.

Meanwhile, the IRS primarily relied upon a procedural argument that Cemco's pleadings had failed to challenge the IRS's legal arguments with sufficient particularity. The IRS claimed that this alleged deficiency constituted a binding concession that the IRS's legal theories were correct.

On March 27, 2007, the district court granted the IRS summary judgment. Rather than relying upon the IRS's procedural argument, however, the court made a *sua sponte* determination that the new legal rule set forth in Treas. Reg. § 1.752–6 was retroactively applicable to Cemco's transactions, and then concluded that the new regulation negated Cemco's claimed loss. App. 22–23. Though the district court viewed Cemco's penalty-statute arguments as "valiant," the court also ruled that a valuation-misstatement penalty could be assessed against Cemco, and rejected Cemco's other arguments. App. 33–34 (citing *Santa Monica Pictures, LLC v. Comm'r*, 89 T.C.M. 1157 (2005)). Cemco timely appealed to the Seventh Circuit.

5. On appeal, Cemco stressed that the newly-promulgated Treas. Reg. § 1.752–6 was impermissibly retroactive, such that the IRS could *not* legitimately apply it to transactions that far preceded its date of adoption. *See* C.A. Appellants' Br. at 18 (citing *Klamath Strategic Inv. Fund, LLC v. United States*, 440 F. Supp. 2d 608, 623, 625 (E.D. Tex. 2006) (holding Treas. Reg. § 1.752–6 impermissibly retroactive)). Under this view, Cemco could not be held accountable for the IRS's decision to revoke *Helmer* long after Cemco had relied upon it. Cemco also reasserted its principal arguments made before the district court: that the IRS's adjustment was procedurally barred, and that, in any event, the valuation-misstatement penalty could not apply.

The Seventh Circuit affirmed the district court's decision, but relied upon very different logic in order

to do so. The court began its opinion with a brief discussion of its intuitive impressions of the transaction at issue, leading it to conclude that the transaction "seem[ed] to lack economic substance." App. 4. With this predicate assumption regarding economic substance in place, the court then rejected Cemco's argument that Treas. Reg. § 1.752–6 could not be applied retroactively, stating that any retroactivity concerns were irrelevant "because all the regulation does is instantiate the pre-existing norm that transactions with no economic substance don't reduce people's taxes." App. 7–8 (citing *Coltec Indus., Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006)). Having determined that the deduction disallowance was legitimate, the court made no effort to address whether the 40% penalty under § 6662 could properly be applied to Cemco's underpayment, even though the parties had briefed the issue in detail.

REASONS FOR GRANTING THE PETITION

This case presents a classic illustration of how the lack of consistency and coherence in tax jurisprudence throughout the lower courts creates traps for even the most sophisticated of taxpayers.

Relying on the law in effect at the time, Cemco engaged in a business transaction and then claimed a tax deduction for the part of that transaction that resulted in a tax loss. What followed, however, was more the product of an unstable legal regime than any act of Cemco's. First, the Seventh Circuit held that the IRS could wholly disregard Cemco's transaction based on the economic substance

doctrine. Then, the court allowed the IRS to go one step further and impose on Cemco a valuation-misstatement penalty, even though Cemco had not misstated the *value* of anything. The result is a tax regime under which deductions can be disallowed without predictability, with substantial penalties imposed in the wake of every denial.

Unfortunately, this regime is not merely the product of the Seventh Circuit's decision below. Instead, it is the result of two well-established circuit splits that lie at the heart of the matter now before this Court. Through its decision below, the Seventh Circuit entered both a three-way circuit split on the meaning of the economic substance doctrine and a two-way split on the meaning of the valuation-misstatement penalty statute, and in the process contradicted the holdings of this Court. Review is therefore necessary to resolve the conflicts between the lower courts and to restore consistency, coherence, and predictability to the administration and application of our nation's tax laws.

I. The Decision Below Deepens a Three-Way Conflict Regarding The Proper Application of the Economic Substance Doctrine.

The foundation of the decision below is the court's intuitive belief that Cemco's deduction should be disregarded under the economic substance doctrine.[5] App. 4 ("The deal as a whole *seems* to lack

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[5] Courts have referred to this doctrine under many names, including the "economic substance" doctrine, the

economic substance[.]") (emphasis added). Cemco strenuously argued below that Treas. Reg. § 1.752–6 could not be retroactively applied to disallow Cemco's claimed deduction. The court of appeals side-stepped this point by concluding that the regulation merely served to "instantiate the pre-existing norm that transactions with no economic substance don't reduce people's taxes," App. 7–8, rather than engaging in any conventional retroactivity analysis. Based on this conclusion, the Seventh Circuit rejected Cemco's argument that it was the victim of an impermissibly-retroactive regulation and affirmed the IRS's disallowance of Cemco's claimed loss.

The Seventh Circuit's conclusory statements about economic substance mask a contentious underlying dispute. The decision makes no mention of the fact that the courts of appeals have adopted three different tests governing whether a transaction can be disregarded under the economic substance doctrine—there is no "pre-existing norm" here for a regulation to "instantiate." Rather, the Seventh Circuit subtly adopted a view of the doctrine that conflicts with the holdings of at least five other circuits, and that contradicts the holdings of this Court.

"substance-over-form" doctrine, and the "sham-transaction" doctrine. *See* Donald L. Korb, *Korb Gives Speech on Economic Substance Doctrine* (Jan. 25, 2005), *available at* 2005 TNT 16-22 (LEXIS) (noting that the same doctrine goes by many names). This petition primarily refers to it as the "economic substance" doctrine, as the Seventh Circuit did below.

A. The Circuits Have Adopted Three Competing Economic Substance Tests.

This Court has long held that "sham transactions . . . should not be recognized for tax purposes." *United States v. Consumer Life Ins. Co.*, 430 U.S. 725, 736–737 (1977) (citing *Gregory v. Helvering*, 293 U.S. 465, 470 (1935)). At the same time, this Court has also stressed that the government must honor any "genuine, multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached." *Frank Lyon Co. v. United States*, 435 U.S. 561, 583–584 (1978). In the wake of *Frank Lyon*, courts have thus generally agreed upon the two critical elements of any economic substance analysis: the objective economic substance of the transaction, and the subjective business purposes that underlie it. *See, e.g., Winn-Dixie Stores, Inc. v. Comm'r*, 254 F.3d 1313, 1316 (11th Cir. 2001).

The lower courts have diverged, however, regarding how these two factors interact, creating a three-way circuit split over the nature and application of the economic substance doctrine. Three distinct and contradictory tests have thus emerged:

1. *The Conjunctive Test.* Two courts of appeals treat the "economic substance" and "business purpose" factors as *conjunctive*, meaning that a court

can disregard a transaction for tax purposes only if both factors are absent. As the Fourth Circuit has explained, "[t]o treat a transaction as a sham, the court must find that [(1)] the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, *and* [(2)] that the transaction has no economic substance because no reasonable possibility of a profit exists." *Rice's Toyota World, Inc. v. Comm'r*, 752 F.2d 89, 91 (4th Cir. 1985) (emphasis added). Under the first element of this formulation, "a transaction cannot be treated as a sham unless the transaction is shaped *solely* by tax avoidance considerations." *Id.* at 92 (emphasis added); *see also Black & Decker Corp. v. United States*, 436 F.3d 431, 441 (4th Cir. 2006).

The D.C. Circuit has adopted the same rule. Recognizing that this Court's opinions in *Frank Lyon* and *Consumer Life* "demonstrate[] the separability of the 'business purpose' and the economic gain tests," the D.C. Circuit mandates that "'[o]nly if *neither* test were satisfied would the transaction be considered a sham.'" *Horn v. Comm'r*, 968 F.2d 1229, 1237–1238 (D.C. Cir. 1992) (quoting Karen N. Moore, *The Sham Transaction Doctrine: An Outmoded and Unnecessary Approach to Combating Tax Avoidance*, 41 FLA. L. REV. 659, 670 (1989)) (emphasis added).

Under this conjunctive test, even if there were a lack of a reasonable possibility of profit under the second factor, that would *not* be enough to allow a court to reject a transaction under the doctrine. Instead, to disregard a transaction for tax purposes, the court must also consider the business purposes

underlying it. *See, e.g.*, *Horn*, 968 F.2d at 1237 (transaction may be upheld "*even* if there was no objectively reasonable possibility that the transaction would produce profits" (emphasis in original)).

2. *The Disjunctive Test.* At the opposite extreme lie three circuits that have adopted a *disjunctive* reading of the same two factors. As the Eleventh Circuit has articulated, "the sham-transaction doctrine . . . provides that a transaction is not entitled to tax respect if [(1)] it lacks economic effects or substance other than the generation of tax benefits, *or* [(2)] if the transaction serves no business purpose." *Winn-Dixie*, 254 F.3d at 1316 (emphasis added). Under this interpretation, the absence of *either factor*—economic effects *or* business purpose—serves to invalidate the entire transaction. *See, e.g.*, *Kirchman v. Comm'r*, 862 F.2d 1486, 1492 (11th Cir. 1989) (lack of economic effects negates any need to consider intent or business purpose); *UPS v. Comm'r*, 254 F.3d 1014, 1018 (11th Cir. 2001) (stating that transaction without business purpose must be disregarded even if it has economic effects).

The Sixth and Federal Circuits have both adopted this same disjunctive analysis. *Dow Chem. Co. v. United States*, 435 F.3d 594, 599 (6th Cir. 2006) (lack of economic effects invalidates transaction regardless of intent); *Coltec Indus. Inc. v. United States*, 454 F.3d 1340, 1355 (Fed. Cir. 2006) ("[A] lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance."). In the process, the courts have candidly acknowledged the

apparent conflict between the conjunctive and disjunctive tests. *See, e.g.*, *Coltec*, 454 F.3d at 1355 & n.14 (adopting disjunctive test; noting conflict with Fourth Circuit conjunctive test).

3. *The Unitary Test.* Yet a third group of courts has attempted to chart a middle path between the conjunctive and disjunctive tests. *See ACM P'ship v. Comm'r*, 157 F.3d 231, 247 (3d Cir. 1998); *Casebeer v. Comm'r*, 909 F.2d 1360, 1363 (9th Cir. 1990); *James v. Comm'r*, 899 F.2d 905, 908–909 (10th Cir. 1990). Under this *unitary* standard, courts recognize that the economic substance doctrine requires consideration of *both* business purpose and economic substance—a rejection of the disjunctive test's premise that the absence of either one, standing alone, renders a transaction a sham. *See, e.g.*, *ACM*, 157 F.3d at 251–257 (considering business purpose even though transaction lacked economic substance). On the other hand, unitary-test courts also reject the conjunctive test's reasoning that the presence of either economic substance or business purpose requires that the transaction be upheld. *See, e.g.*, *Casebeer*, 909 F.2d at 1363 (expressly rejecting Fourth Circuit conjunctive test). Instead, these three circuits treat economic substance and business purpose "not [as] discrete prongs of a rigid two-step analysis, but rather [as] related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes." *ACM*, 157 F.3d at 247 (quoting *Casebeer*, 909 F.2d at 1363) (internal quotation marks omitted).

The three-way division between the conjunctive, disjunctive, and unitary tests has long been recognized as a substantial circuit split. Even the IRS's chief counsel has acknowledged that the conflict invites this Court's attention. *Korb Acknowledges U.S. Supreme Court May Need to Clarify Economic Substance Doctrine*, Daily Tax Rep. (BNA) (Oct. 27, 2006); *see also* Korb, *supra* n.5. As such, it is not surprising that courts throughout the country evaluating transactions almost identical to Cemco's have reached contrary conclusions under divergent legal standards. *Compare Sala v. United States*, No. 05-cv-00636, 2008 U.S. Dist. LEXIS 37087 (E.D. Colo. Apr. 22, 2008) (upholding similar transaction under unitary test), *with Jade Trading, LLC v. United States*, 80 Fed. Cl. 11 (2007) (rejecting same under disjunctive test).[6]

The decision below thus injects further confusion into this already overcomplicated area of law. Under the most charitable reading of the decision below, the Seventh Circuit subtly adopted the disjunctive test.[7] Echoing language from the first prong of the disjunctive test, it concluded that the IRS could disregard Cemco's transaction solely because transactions without economic substance are invalid,

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[6] This issue is further complicated by several subsidiary splits in the doctrine, including disagreement regarding the appropriate standard of review applied to economic substance determinations. *See, e.g.*, *James*, 899 F.2d at 909 & n.5.

[7] The only alternative—that the Seventh Circuit abandoned all three prevailing tests in favor of its own intuition—would only increase the need for this Court's intervention.

with no effort to consider Cemco's business purposes. App. 7–8. In so holding, the court cited only the Federal Circuit's recent opinion in *Coltec*—a case expressly adopting the disjunctive test. App. 8. To make matters worse, the court did not conduct any meaningful analysis of the economics pertinent to the only factor it *did* consider, relying instead on its intuitive belief that Cemco's transaction lacked economic substance. App. 3, 7–8.

As a result, the Seventh Circuit made no effort to address an element of the economic substance doctrine that at least five circuits consider mandatory: the subjective business purposes underlying the transaction. Federal courts in over half of the country would have analyzed Cemco's deduction under a different legal standard and, most likely, reached a different conclusion. But because the Seventh Circuit never addressed or analyzed Cemco's subjective business purposes, Cemco never received the benefit of such scrutiny.

The instant case provides this Court with a meaningful opportunity to address this schism between the circuits, to establish a meaningful, uniform understanding of the economic substance doctrine, and to restore uniformity to this aspect of our nation's tax laws.

B. The Test Endorsed by the Opinion Below Contradicts This Court's Holdings.

Through its decision below, the Seventh Circuit disregarded Cemco's transaction under the economic

substance doctrine based solely upon its comparison of Cemco's investments to their anticipated tax benefits. Such an approach cannot be reconciled with this Court's instructions.

As noted above, this Court has consistently pointed to two separate factors governing the validity of a transaction under the economic substance doctrine. *See, e.g.*, *Frank Lyon*, 435 U.S. at 583–584 (discussing both factors); *Consumer Life*, 430 U.S. at 737 (same). This Court has thus emphasized that proper analysis under the economic substance doctrine *requires* consideration of both the transaction's economic effects *and* the taxpayer's subjective purposes. Focus on *both* of these factors is compelled by this Court's separate treatment of each.

On one hand, this Court has established—contrary to the decision below—that a disproportionate tax benefit on its own *cannot* serve to invalidate a transaction that is authorized under the tax code. *See Gitlitz v. Comm'r*, 531 U.S. 206, 219–220 (2001) (rejecting IRS effort to invalidate basis calculation due to alleged "windfall" received by taxpayer); *see also Indianapolis Life Ins. Co. v. United States*, 115 F.3d 430, 433 (7th Cir. 1997) (rejecting "windfall" claim; acknowledging that the Code includes both intentional and unintentional loopholes). Here, Cemco claimed a tax loss based on the ordinary application of complicated but legitimate basis rules. Any tension between the basis determination and the court's intuitive sense of value is irrelevant when Congress has chosen not to link the two. *See, e.g.*, 26 U.S.C. §§ 358(a)(2), 1014,

"whether the new regulation changed settled law" is a critical factor of any retroactivity analysis. *See, e.g.*, *Klamath*, 440 F. Supp. 2d at 623 (citing *Snap-Drape, Inc. v. Comm'r*, 98 F.3d 194 (5th Cir. 1996)) (holding that Treas. Reg. § 1.752–6 could not be retroactively applied because it changed settled law).

The decision below is therefore in error. Application of the proper economic substance test—the conjunctive test—would have confirmed the validity of Cemco's transaction under prevailing law, establishing that the IRS's new contrary regulation could not be retroactively applied as having "instantiated" the economic substance doctrine.

II. The Decision Below Also Deepens a Mature 5-2 Circuit Split Regarding the Applicability of the Valuation-Misstatement Penalty Statute.

Even if the IRS properly disallowed Cemco's loss deduction, it does not follow that it was authorized to impose a valuation-misstatement penalty in this case. By affirming a valuation-misstatement penalty when the IRS denied a claimed deduction for legal reasons, the Seventh Circuit took sides in a second well-established circuit split, contradicting both the relevant statutory text and this Court's prior decisions.

A. The Courts of Appeals Have Adopted Conflicting Interpretations of the Statute.

By its terms, the valuation-misstatement penalty statue applies only when an underpayment

is "attributable to . . . [a] valuation misstatement." 26 U.S.C. § 6662(b)(3).[9] In light of this textual mandate, the Fifth and Ninth Circuits have recognized that the valuation-misstatement statute cannot apply when the IRS denies a claimed deduction for legal reasons unrelated to an asset's value:

> Whenever the I.R.S. totally disallows a deduction or credit . . . the [resulting] underpayment is not *attributable to* a valuation overstatement. Instead, it is *attributable to* claiming an improper deduction or credit.

Heasley v. Comm'r, 902 F.2d 380, 383 (5th Cir. 1990) (emphasis added); *see also Todd v. Comm'r*, 862 F.2d 540, 541–542 (5th Cir. 1988); *Gainer v. Comm'r*, 893 F.2d 225, 226–227 (9th Cir. 1990). Under this interpretation, a simple difference of opinion between a taxpayer and the IRS regarding a legal rule cannot expose the taxpayer to a valuation-misstatement penalty; any underpayment results from the legal error in *claiming* the deduction, not from a misstatement of value.

By contrast, five circuits have reached an opposite conclusion, taking a broad view of § 6662's applicability. *See Gilman v. Comm'r*, 933 F.2d 143

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[9] Section 6662(b)(3)'s predecessor, 26 U.S.C. § 6659 (1981), included the same "attributable to" language. Therefore, cases interpreting former § 6659 are applicable to modern § 6622. *See, e.g., Santa Monica Pictures*, 89 T.C.M. 1157. Accordingly, petitioners do not distinguish between cases interpreting modern § 6662 and cases interpreting prior versions of the statute.

(2d Cir. 1991); *Merino v. Comm'r*, 196 F.3d 147 (3d Cir. 1999); *Zfass v. Comm'r*, 118 F.3d 184 (4th Cir. 1997); *Illes v. Comm'r*, 982 F.2d 163 (6th Cir. 1992); *Massengill v. Comm'r*, 876 F.2d 616 (8th Cir. 1989). Under this line of cases, even when an underpayment "'stems from disallowed depreciation deductions or investment credits due to lack of economic substance,'" the IRS may impose a valuation-misstatement penalty. *Gilman*, 933 F.2d at 151 (quoting *Massengill*, 876 F.2d at 619–620)).

The existence of this circuit split is well known, and its impact is well established. The relevant cases candidly acknowledge that they are in conflict with each other. *See, e.g.*, *Zfass*, 118 F.2d at 190–191 (noting disagreement among the circuits). Practitioners and scholars have similarly acknowledged the divisions between the courts of appeals on this issue. *See, e.g.*, Federal Tax Coordinator at V-2243 (2d ed. 2008). The IRS has, through internal memoranda, both noted the split and developed a series of aggressive litigation strategies designed to undermine the *Heasley* rule. *See* IRS Litigation Memo (Aug. 12, 1992).[10] Meanwhile, in the face of these competing interpretations the Tax Court has responded inconsistently, at times applying *Heasley* while at others siding with *Gilman*. *Compare Rasmussen v.*

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[10] As a result, this penalty issue now often arises in cases in which the economic substance doctrine is also at issue, as the IRS regularly asserts the penalty in cases in which it views a transaction as lacking economic substance. *See, e.g.*, *Sala*, 2008 U.S. Dist. LEXIS 37087; *Klamath Strategic Inv. Fund, LLC v. United States*, 472 F. Supp. 2d 885 (E.D. Tex. 2007).

Comm'r, 63 T.C.M. 2710 (1992) (applying *Heasley*) *with Vangeloff v. Comm'r*, 64 T.C.M. 660 (1992) (rejecting *Heasley*).

The instant case provides a solid vehicle for this Court to resolve this longstanding circuit split. Cemco argued, both before the district and circuit courts, that the IRS could not apply § 6662 against it. By rejecting Cemco's challenge to the valuation-misstatement penalty, the Seventh Circuit implicitly sided with those courts that take a broad view of the penalty and apply the *Gilman* rule. Had the court instead adopted the narrower view of the Fifth and Ninth Circuits, the IRS should not have been permitted to impose such a penalty against Cemco. Though the Seventh Circuit did not discuss the valuation-misstatement statute, its affirmance of the district court's decision and the statutory penalty serves to preserve the issue for this Court's review. *United States v. Williams*, 504 U.S. 36, 41 (1992) (holding that the traditional "pressed or passed upon" rule for granting certiorari requires only that a claim be "pressed" *or* "passed upon," not both).

This petition thus presents a classic example of the IRS imposing a valuation-misstatement penalty purely based upon the denial of a deduction for wholly legal, not factual, reasons—the precise issue that has long divided the courts of appeals.

B. The Decision Below Contradicts the Statute's Text and History and Stands in Tension With This Court's Precedent.

As the Fifth and Ninth Circuits correctly understand, the accuracy-related penalty authorized in § 6662 is narrowly circumscribed. The statute does not apply to *every* underpayment, but rather, only those underpayments "attributable to" a valuation misstatement. Valuation misstatements raise predominantly questions of fact—for example, when a taxpayer supports its return with a factually-incorrect appraisal of the value of an asset. *See, e.g.*, *Todd*, 862 F.2d at 544 n.15 ("Congress recognized that valuation questions involve difficult factual determinations."). By contrast, deductions are often disallowed for purely legal reasons that have nothing to do with a dispute over asset valuation. In the latter situations, any resulting underpayments are therefore not "attributable to" a valuation misstatement, rendering § 6662 inapplicable.

When Congress first adopted the valuation-misstatement penalty, it shared this understanding of the provision's scope. Congress designed the valuation-misstatement penalty to target a specific abuse: taxpayers who intentionally overvalue property to exploit the factual difficulties inherent in resolving true valuation disputes. *See* U.S. House of Representatives Committee on Ways & Means, Report on H.R. 4242, H.R. Doc. No. 97-201, at 243 (1981). Thus, in its classic application, the penalty should not apply in cases where the IRS disallows a deduction for purely legal reasons, such as the

economic substance doctrine. Rather, it applies when "a taxpayer claims for an asset a value that the Commissioner determines is unduly high," such as an "inflated value claimed for a work of art in order to obtain a large deduction for a charitable donation." *Gilman*, 933 F.2d at 150 (discussing examples from legislative history of original version of penalty). This understanding of the penalty is confirmed by the IRS "blue book," which has long emphasized the distinction between underpayments attributable to "valuation misstatements" and those resulting from "other adjustments to tax liability." *See Todd*, 862 F.2d at 542–543 (quoting General Explanation of the Economic Recovery Tax Act of 1981 discussion of immediate predecessor to § 6662).[11] Nothing in the statute's history supports its application when the IRS disallows a deduction for legal reasons that do not involve any dispute over value, such as the economic substance doctrine or application of Treas. Reg. 1.752–6: *i.e.*, the instant case.

Indeed, cases adopting the erroneous, broad view of the applicability of § 6662 have acknowledged that their expansive reading "strains the natural reading of the statutory phrase," *Gilman*, 933 F.2d at 151, standing in tension with the statute's text, history, and purpose. The better view is that adopted by the Fifth and Ninth Circuits: that underpayments due to

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[11] This Court has previously relied upon similar blue books when construing other sections of the tax code. *See, e.g., Fed. Power Comm'n v. Memphis Light, Gas & Water Div.*, 411 U.S. 458, 471–472 (1973) (interpreting Tax Reform Act of 1969).

deductions wholly disallowed for purely legal reasons are different in *kind*—not *degree*—from those disallowed because of a valuation overstatement. *See Heasley*, 902 F.2d at 383; *cf. Gilman*, 933 F.2d at 151 ("[A]rguably the overvaluation in a sham transaction is different in kind, not merely degree.")

At a minimum, courts on both sides of this divide have *agreed* that § 6662 is ambiguous. *See Gainer*, 893 F.2d at 227 (discussing "ambiguities" in the section); *Todd*, 862 F.2d at 542 ("[W]e find the language of the statute ambiguous."); *Gilman*, 933 F.2d at 150 (application of valuation-misstatement penalty in cases where deductions are deemed to be without economic substance "fairly questionable"). As a result, the Seventh Circuit's adoption of the broad *Gilman* interpretation contradicts this Court's mandates that ambiguous tax statutes be construed *favorably* to taxpayers, *see, e.g.*, *Bowers v. New York & Albany Lighterage Co.*, 273 U.S. 346, 350 (1927), and that tax penalty statutes be strictly construed *against* the IRS, *Ivan Allen Co. v. United States*, 422 U.S. 617, 627 (1975). The decision below, like all of the cases in the *Gilman* line, improperly disregards this Court's rules of lenity.

Thus, the statute's text, history, and purpose, as well as this Court's guidance, are all in accord, and are aligned against the rule adopted by the decision below.

III. This Court's Review Is Necessary and Warranted to Restore Fair and Uniform Application of Federal Tax Laws.

Left uncorrected, the Seventh Circuit's errors below (and the underlying circuit splits those errors implicate) will have a widespread and lasting impact.

First, as noted above, the court of appeals' application of the economic substance doctrine adds even more uncertainty to the already-complicated field of tax planning. Taxpayers need to predict, *ex ante* and with reasonable accuracy, the tax consequences of transactions they contemplate. Doctrinal disarray is especially intolerable given the typically high financial stakes raised through transactions that the IRS seeks to disqualify. *See* Eileen J. O'Connor, *Enforcement is Progressing, Justice Department Attorney Testifies At Senate Finance Hearing*, 114 Tax Notes 42 (June 14, 2006). Unless this Court finally provides a uniform interpretation of the economic substance doctrine, the validity of transactions will continue to hinge more upon the circuit in which suit is brought than the substance of the transaction itself. *See* John F. Prusiecki, *Coltec: A Case of Misdirected Analysis of Economic Substance*, 112 Tax Notes 524 (Aug. 7, 2006) (describing doctrine as "an all-purpose talisman to be invoked by the court at its discretion in setting tax policy").

Second, the overly-broad interpretation of § 6662 urged by the IRS over the years ensures that valuation-misstatement penalties will attach

whenever a deduction is wholly disallowed, whether under the economic substance doctrine or for a mistake under the legal rules for computing basis. As most disputes between the IRS and a taxpayer implicate basis in *some* way, all such disputes would pose the threat of unintended and disproportionate punishment. Indeed, the penalty system's percentage-based benchmarks ensure that underpayments resulting from disallowed deductions must be treated as *gross* violations and punished through imposition of the maximum 40% penalty, regardless of the actual amount of the deduction itself.[12] Continued misconstruction of § 6662 will thus subject taxpayers to excessive penalties for innocent and commonplace legal errors, arising out of countless everyday transactions.

The IRS's treatment of Cemco highlights the gross inequity created by the intersection of these two lines of cases. As explained above, Cemco's reporting of its loss deduction was accurate under

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[12] Under the IRS's logic, as the total disallowance of a deduction on economic substance grounds lowers its value or basis to zero, "[t]he percent of 'overvaluation' above zero is *infinite*," which is "literally" greater than the statutory gross-penalty threshold. *See Gilman*, 933 F.2d at 151 (emphasis added); *see also* C.A. Appellee's Br. at 64 & n.28. Rather than relying upon a divide-by-zero error to justify imposition of a maximum penalty, the better view is to recognize that "where the taxpayer's basis has been reduced to zero, it is somewhat odd to apply a provision that scales the penalty rates to the percentage of overvaluation," *Gilman*, 933 F.2d at 151—further evidence that § 6662 should not apply when a claimed deduction is disallowed on legal grounds.

the prevailing law at the time it filed its tax returns. But when the IRS changed the governing rules through a *post-facto* regulation, the Seventh Circuit first relied upon an expansive misinterpretation of the economic substance doctrine to invalidate the transaction, and then affirmed the imposition of a gross valuation-misstatement penalty even though the dispute between Cemco and the IRS turned on a wholly legal issue unrelated to valuation.

Standardization of the economic substance doctrine would promote the consistent treatment of taxpayers across the country. Meanwhile, proper interpretation of the valuation-misstatement penalty statute would protect taxpayers by ensuring that changes in law will not subject them to expansive, unforeseen liability. The instant case provides this Court with an appropriate vehicle through which to resolve these longstanding splits, to restore the correct interpretation of our nation's tax law and this Court's precedents, and to provide taxpayers with uniformity that has long been absent from this critical area of law.

These conflicts will not resolve themselves without this Court's intervention. As explained above, the circuit splits regarding the economic substance doctrine and the valuation-misstatement penalty are firmly entrenched. No evidence suggests that the lower courts will suddenly and spontaneously seek, let alone *achieve*, unanimity. The need for predictability and stability in this important area of law thus requires action from this Court.

CONCLUSION

For the reasons provided above, the Court should grant the petition for a writ of certiorari.

Respectfully submitted,

THOMAS D. SYKES
McDERMOTT WILL & EMERY LLP
227 W. Monroe St., 56th Floor
Chicago, Illinois 60606
(312) 372-2000

RORY K. LITTLE
HASTINGS COLLEGE OF LAW (U.C.)
200 McAllister St.
San Francisco, CA 94102
(415) 565-4669

M. MILLER BAKER
Counsel of Record
PAUL M. THOMPSON
JEFFREY W. MIKONI
McDERMOTT WILL & EMERY LLP
600 Thirteenth St., N.W.
Washington, D.C. 20005
(202) 756-8000

Attorneys for Petitioners

June 6, 2008

APPENDIX

APPENDIX A
Opinion of the United States Court of Appeals for the Seventh Circuit (filed Feb. 7, 2008)

CEMCO INVESTORS, LLC, AND
FOREST CHARTERED HOLDINGS LTD.,
Plaintiffs-Appellants,

v.

UNITED STATES OF AMERICA,
Defendant-Appellee.

No. 07-2220

United States Court of Appeals
for the Seventh Circuit

515 F.3d 749

December 7, 2007, Argued
February 7, 2008, Decided

For CEMCO INVESTORS, a limited liability company treated as a partnership, Plaintiff-Appellant: Thomas D. Sykes, MCDERMOTT, WILL & EMERY, Chicago, IL.

For FOREST CHARTERED HOLDINGS, Tax Matters Partners, Plaintiff - Appellant: Thomas D. Sykes, MCDERMOTT, WILL & EMERY, Chicago, IL.

For UNITED STATES OF AMERICA, Defendant - Appellee: Arthur T. Catterall, DEPARTMENT OF JUSTICE, Civil Division, Immigration Litigation, Washington, DC.

Before EASTERBROOK, *Chief Judge*, and MANION and KANNE, *Circuit Judges*.

EASTERBROOK, *Chief Judge*. Paul M. Daugerdas, a tax lawyer whose opinion letters while at Jenkins & Gilchrist led to the firm's demise (it had to pay more than $ 75 million in penalties on account of his work), designed a tax shelter for himself, with one client owning a 37% share. Like many tax shelters it was complex in detail but simple in principle, and to facilitate exposition we cover only its basics, rounding all figures.

Four entities played a role: Cemco Investors, a limited liability company that for tax purposes is treated as a partnership (so that its profits and losses are passed through to its owners); Cemco Investment Partners (the Partnership), Cemco Investors Trust (the Trust), and Deutsche Bank. (Forest Chartered Holdings, which Daugerdas controls, is Cemco's tax-matters partner. It handles Cemco's tax paperwork and has managed this litigation but did not participate in the underlying transactions. We do not mention it again.)

In December 2000 the Trust purchased from Deutsche Bank two options in euros, one long and one short. The long position had a premium of $ 3.6 million (nominally paid to Deutsche Bank) and entitled the Trust to $ 7.2 million if, two weeks in

the future, the euro was trading at $ .8652 or lower. (Back in 2000 the dollar was worth more than the euro.) The short position had roughly the same premium (nominally paid by Deutsche Bank to the Trust) and required the Trust to pay Deutsche Bank $ 7.2 million if, on the same date, the euro exchange rate was $ .8650 or lower. In other words, if on the exercise date the euro was worth $ .8652 or more, or $ .8650 or less, the long and short positions would cancel out; but if the euro was trading for $ .8651 on December 19, 2000, then Deutsche Bank would pay $ 7.2 million to the Trust. Like the options, the premiums matched almost exactly. The only money that changed hands was $ 36,000, which the Trust paid Deutsche Bank as the difference between the long and short premiums. And Deutsche Bank promised to refund $ 30,000 of this $ 36,000 if the options offset on the exercise date.

The Trust assigned its rights in these options to the Partnership, contributing some cash as well. The partnership spent about $ 50,000 to buy euros at an exchange rate of .89 dollars per euro. The next day Deutsche Bank remitted $ 30,000, because the options had offset. Soon the Partnership liquidated and distributed its assets (both dollars and euros) to the Trust. Next the Trust transferred to Cemco the (euro) 56,000 it had received from the Partner-ship. Finally, on the year's last business day, Cemco sold the euros for $ 50,000.

One would think from this description that the Trust (and the Partnership as its assignee) suffered a loss of $ 6,000--the net premium paid for options that cancelled each other out and hence lacked value

on the exercise date--while Cemco had neither profit nor loss. Yet Cemco filed a tax return for 2000 showing a loss of $ 3.6 million! Its theory was that the Partnership's euros (later contributed to Cemco) had the same $ 3.6 million basis as the long option, and that a loss could be recognized once the euros had been sold. Cemco passed the loss to Daugerdas and his client, who reported it on their tax returns. What of the $ 3.6 million that Deutsche Bank "paid" the Trust for the short option, which almost exactly offset the long option? Well, Cemco took the view that this stayed with the Trust--and would never be taxed *to* the Trust, which, after all, had a net loss of $ 6,000--or if assumed by Cemco may be ignored because the options offset in the end. The purchase and sale of euros was the device used to transfer the basis of one option to Cemco while consigning the other option to oblivion.

A transaction with an out-of-pocket cost of $ 6,000 and no risk beyond that expense, while generating a tax loss of $ 3.6 million, is the sort of thing that the Internal Revenue Service frowns on. The deal as a whole seems to lack economic substance; if it has any substance (a few thousand dollars paid to purchase a slight chance of a big payoff) then the $ 3.6 million "gain" on one premium should be paired with the $ 3.6 million "loss" on the other; and at all events the deal's nature ($ 36,000 paid for a slim chance to receive $ 7.2 million) is not accurately reflected by treating (euro) 56,000 as having a basis of $ 3.6 million. The IRS sent Cemco a Notice of Final Partnership Administrative Adjustment disallowing the loss and assessing a 40% penalty for Cemco's grossly incorrect return. In the

ensuing litigation, the district court sided with the IRS. 2007 U.S. Dist. LEXIS 22246 (N.D. Ill. Mar. 27, 2007).

Cemco says that in treating $ 50,000 of euros as having a $ 3.6 million basis, which turned into a loss when the euros were sold for exactly what they had been worth all along, it was just relying on *Helmer v. CIR*, T.C. Memo 1975-160, 34 T.C.M. 727 (1975), and a few similar decisions. That may or may not be the right way to understand *Helmer;* we need not decide, for it is not controlling in this court--or anywhere else. The Commissioner has a statutory power to disregard transactions that lack economic substance. Compare *Gregory v. Helvering*, 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed. 596 (1935), with *Frank Lyon Co. v. United States*, 435 U.S. 561, 98 S. Ct. 1291, 55 L. Ed. 2d 550 (1978). And the IRS has considerable latitude in issuing regulations that specify sorts of transactions that may be looked through. (These regulations avoid the need to litigate, one tax shelter at a time, whether any real economic transaction is inside the box.) A few months before Daugerdas set up this tax shelter, the IRS had issued Notice 2000-44, 2000-2 C.B. 255, alerting taxpayers to its view that *Helmer* could not be relied on, that purported losses from transactions that assigned artificially high basis to partnership assets would be disallowed, and that formal regulations to this effect were on their way. One of the transactions covered in Notice 2000-44 is the offsetting-option device.

Getting from a warning to a regulation often takes years, however, and did so here. Treasury Regulation § 1.752-6, 26 C.F.R. § 1.752-6, was issued

in temporary form in 2003. T.D. 9062, 2003-2 C.B. 46. Two more years passed before the temporary regulation was made permanent. T.D. 9207, 2005-1 C.B. 1344, 70 Fed. Reg. 30334 (May 26, 2005). This sets the stage for Cemco's principal argument. It concedes that Notice 2000-44 and Treas. Reg. 1.752-6 scupper the entire class of offsetting-option tax shelters. The regulation does this by subtracting, from the partnership's basis in an asset, the value of any corresponding liability. Thus if Cemco's basis in the euros comes from the premium for one option, then the premium for the offsetting option must be subtracted. That gets the basis back to roughly $ 50,000 (the value of the euros) + $ 6,000 (the difference in the premiums). But as Cemco sees things the notice lacks legal effect, while the regulation cannot be applied retroactively. One district court has held that Treas. Reg. § 1.752-6 does not affect transactions that predate it. *Klamath Strategic Investment Fund, LLC v. United States*, 440 F. Supp. 2d 608 (E.D. Tex. 2006). We disagree with that conclusion.

The regulation could not be more explicit: "This section applies to assumptions of liabilities occurring after October 18, 1999, and before June 24, 2003." Treas. Reg. § 1.752-6(d)(1). (Transactions after June 23, 2003, are governed by the more elaborate 26 C.F.R. § 1.752-7.) Why October 18, 1999? Because, HN3 although regulations generally do not apply to transactions that occur before the initial publication date of a draft regulation, see 26 U.S.C. § 7805(b)(1)(C), the norm of prospective application "may be superseded by a legislative grant from Congress authorizing the Secretary to prescribe the

effective date with respect to any regulation." 26 U.S.C. § 7805(b)(6). Section 309 of the Community Renewal Tax Relief Act of 2000, Pub. L. 106-554, 114 Stat. 2763A-587, 638 (2000), enacts basis-reduction rules for many transactions and authorizes the IRS to adopt regulations prescribing similar rules for partnerships and S corporations. Section 309(d)(2) of the 2000 Act adds that these regulations may be retroactive to October 18, 1999. That's the power the Commissioner used when promulgating Treas. Reg. § 1.752-6.

The district court in *Klamath* did not doubt that retroactivity *could* rest on the 2000 Act; Treas. Reg. § 1.752-6 applies to partnerships (and LLCs treated as partnerships) a rule "similar" to the approach that Congress adopted for other business entities. *Klamath* held, however, that when promulgating Treas. Reg. § 1.752-6 the IRS had not availed itself of that power. But if the IRS was not using that authority, why in the world does the regulation reach back to October 18, 1999? Retroactivity requires justification; to make a rule retroactive is to invoke one of the available justifications; and the choice of date tells us that the justification is the one supplied by the 2000 Act (in conjunction with § 7805(b)(6)). A regulation's legal effect does not depend on reiterating the obvious. So Treas. Reg. § 1.752-6 applies to this deal and prevents Cemco's investors from claiming a loss. Cemco is scarcely in a position to complain--not only because this tax shelter was constructed after the warning in Notice 2000-44, but also because all the regulation does is instantiate the pre-existing norm that transactions with no economic substance don't reduce people's

taxes. See *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006).

Cemco offers several other arguments, only one of which requires discussion. Sections 6221 to 6234 of the Internal Revenue Code link the tax treatment of partners to that of their partnerships. Disputes are resolved in a single proceeding at the partnership level, and each partner then must treat all partnership items on his own return the same way they were treated in that proceeding. 26 U.S.C. § 6222(a). That's why the Commissioner issued the Notice of Final Partnership Administrative Adjustment to Cemco and why it rather than Daugerdas or his client is the plaintiff. Under Treas. Reg. § 301.6231(a)(3)-1, 26 C.F.R. § 301.6231(a)(3)-1, both assets and liabilities can be "partnership items," and this is Cemco's opening. It asks us to treat the euros as a "partnership item" of the Partnership. When the Trust contributed this "partnership item" to Cemco, it had the same basis as in the Partnership's (and later the Trust's) hands. To ensure consistent treatment, Cemco maintains, the IRS should have issued the Notice of Final Partnership Administrative Adjustment to the Partnership instead of Cemco. As long as the euros have a basis of $ 3.6 million for the Partnership and Trust, they must have the same basis for Cemco, the argument concludes.

Cemco's approach misstates the scope of §§ 6221-34. They concern the treatment of "partnership items" *by the partners* of a partnership. Cemco has never been a partner of the Partnership or the Trust. These sections of the Code therefore do not link the

tax treatment of the euros in Cemco's hands to their tax treatment in anyone else's. Cemco is effectively contending that §§ 6221-34 should be extended to create a general requirement of consistency in tax treatment. That sort of argument has been made before--and has been rejected by the Supreme Court. Restaurants must withhold taxes on tips paid to their employees. One restaurant, which had been dunned for underpayment of the withholding tax, insisted that it need not pay until income taxes had been assessed against the employees; otherwise the employees' taxable tip income might be calculated differently for the restaurant and the workers, though the actual level of tips must be the same from either perspective. *United States v. Fior D'Italia, Inc.*, 536 U.S. 238, 122 S. Ct. 2117, 153 L. Ed. 2d 280 (2002), held, however, that the IRS need not ensure consistent tax treatment unless a statute so requires. Sections 6221 to 6234 don't require this, because Cemco is not an investor in the Partnership.

True enough, 26 U.S.C. § 723 provides that Cemco's basis in the euros must equal the basis the asset had for its last owner. But this means the *actual* basis, not whatever number the prior owner chooses to report. The IRS is free to determine assets' correct basis, under governing law, whether or not a former owner has filed a creative tax return full of fanciful numbers. The Partnership did not claim a $ 3.6 million tax shield, so there was no reason for the IRS to spend time or money pinning down the correct tax on its slight income. Cemco's return is what matters to what real taxpayers owe, so it was both sensible and lawful for the Commissioner to issue the Notice of Final

Partnership Administrative Adjustment to Cemco alone. To the extent that *Roberts v. CIR*, 94 T.C. 853 (1990), combines § 723 with § 6222 to produce a requirement that the IRS first recalculate the taxes of whoever contributes an asset to a partnership, the better to ensure consistency, it misreads the Code. Section 6222 requires partnerships and their partners to treat consistently the "partnership items" of that partnership. No statute requires the IRS to treat identically two or more entities just because they have some partners in common (Daugerdas has interests in Cemco, the Trust, and the Partnership).

AFFIRMED

APPENDIX B
Opinion of the United States District Court for the Northern District of Illinois (filed Mar. 27, 2007)

CEMCO INVESTORS, LLC, ET AL.,
Plaintiff,

v.

UNITED STATES OF AMERICA,
Defendant-Appellee.

No. 04 C 8211

United States District Court for the Northern District of Illinois, Eastern Division

2007 U.S. Dist. LEXIS 22246

March 27, 2007, Decided

For Cemco Investors LLC, A Limited Liability Company Treated As A Partnership, Forest Chartered Holdongs, LTD., Tax Matters Partner, Petitioners: David Joseph Duez, LEAD ATTORNEY, Thomas D Sykes, McDermott, Will & Emery LLP, Chicago, IL.

For United States of America, Respondent: John A. Lindquist, III, LEAD ATTORNEY, United States Department of Justice, Tax Division, Washington, DC; AUSA, Samuel D Brooks, United States Attorney's Office (NDIL), Chicago, IL; Dennis M

Donohue, US Department of Justice, Washington, DC.

Judge Joan B. Gottschall

MEMORANDUM OPINION AND ORDER

Petitioner Cemco Investors, LLC[1] ("Cemco") brought this action against respondent, the United States of America, seeking, pursuant to I.R.C. § 6226 (2006), judicial review of a final partnership administrative adjustment ("FPAA") issued to Cemco by the Internal Revenue Service ("IRS"). In the FPAA, the IRS determined that Cemco was a sham partnership existing as an illegal tax shelter, disallowed certain items claimed by Cemco on its year 2000 Form 1065 tax return of partnership income, and assessed several penalties against Cemco for filing an inaccurate return. In this action, Cemco challenges several of the determinations made by the IRS in the FPAA. Both Cemco and respondent have moved for summary judgment. For the reasons set forth below, Cemco's motion for summary judgment is denied and respondent's motion for summary judgment is granted.

I. BACKGROUND

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[1] Formally, the petitioner is actually Forest Chartered Holdings, Ltd., Cemco's tax matters partner that brought this action on behalf of Cemco, but the court refers to Cemco as the petitioner throughout this opinion.

This case centers on the tax implications of a series of business transactions that took place in December of 2000. The facts relating to these transactions, which are those material to the parties' respective summary judgment motions, are not in dispute; this case turns instead on the application and interpretation of specific portions of the Internal Revenue Code ("I.R.C.").[2]

Three entities were involved in the underlying transactions: Cemco, Cemco Investors Trust ("CIT"), and Cemco Investment Partners ("CIP"). Cemco was a limited liability company, CIT was a grantor trust, and CIP was a general partnership. The participants in all three entities were virtually the same. During the relevant time period, both Cemco and CIP consisted of only two partners: Steven Kaplan ("Kaplan") and Forest Chartered Holdings, Ltd. ("Forest"). CIT's beneficiaries were also Kaplan and Forest, and its trustee was Paul Daugerdas ("Daugerdas"). According to respondent, Forest was basically a shell company through which Daugerdas orchestrated the tax shelter scheme at the heart of this case; Daugerdas was Forest's president and sole shareholder, and the address Forest listed as its principal place of business was Daugerdas'

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[2] The factual recitation is drawn from Cemco's Statement of Undisputed Material Facts, respondent's Statement of Material Facts, the Declaration of Paul M. Daugerdas, and the Fifth Declaration of John Lindquist.

residence.[3] Forest was the designated tax matters partner of both Cemco and CIP, and the year 2000 Form 1065 tax returns of partnership income of both Cemco and CIP were prepared and signed by Daugerdas on behalf of Forest.

On December 4, 2000, CIT entered into two foreign exchange digital option transactions with Deutsche Bank ("DB"), a German-based international bank, whereby CIT simultaneously bought a digital foreign currency option for $ 3,600,000 (the "long" or "purchased" option) and sold a foreign digital currency option for $ 3,564,000 (the "short" or "sold" option). The following day, December 5, 2000, CIT assigned the offsetting option

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[3] According to respondent, the offsetting foreign currency option scheme discussed below was Daugerdas' brainchild. Respondent asserts that Kaplan agreed to invest with Daugerdas based on his understanding that Daugerdas would be using his money in an entirely different (and lawful) manner, that Kaplan was unaware of and did not agree that his money would be used in the transactions described below, and that Daugerdas ultimately defrauded Kaplan of $ 600,000. For present purposes, it is unimportant whether these allegations are true. That Cemco's, CIP's, and CIT's strings were being pulled by Daugerdas, not Kaplan, appears to be undisputed; Daugerdas' signed declaration filed in this case supports respondent's position that Daugerdas, a tax attorney, conceived of an carried out the transactions at issue. *See* Decl. Paul M. Daugersas ¶¶ 13a–13e.

contracts to CIP. On December 18, 2000, CIP purchased 55,947.19 in euros ("€") for $ 50,000 through DB. CIP then terminated its and DB's rights and obligations under the option contracts by entering into a "Termination Agreement" with DB on December 19, 2000. Pet'r Statement Undisputed Material Facts ¶ 8d. On December 21, 2000, CIP was liquidated and ninety-nine percent of its property was distributed to CIT by way of a transfer from CIP's DB account to CIT's DB account. At the time of its liquidation, CIP's only assets were $ 45,847.27 and the € 55,947.19 in euros CIP had purchased from DB. On December 26, 2000, CIT "contributed" the euros to Cemco, again by way of deposit to Cemco's DB account. *Id.* ¶ 8g. Finally, on December 29, 2000, Cemco sold the majority of the € 55,947.19 in euros for $ 51,324.58.

Cemco filed its Form 1065 tax return of partnership income for the year ending December 31, 2000, in September of 2001. On that return, Cemco reported a loss of $ 3,563,211.71, which Cemco claimed was a net loss due to the disposition of nonfunctional currency under I.R.C. § 988 (2006)—the sale of the euros on December 29, 2000. According to Daugerdas, this loss is premised on the theory that the euros contributed to Cemco by CIT on December 26, 2000, had an adjusted basis of $ 3,614,536.29. Decl. Paul M. Daugerdas ¶ 13. Daugerdas' theory regarding the adjusted basis of the euros begins with CIP. Daugerdas asserts that CIP calculated the adjusted basis of the options assigned to it by CIT on December 5, 2000, at $ 3,600,000 by taking into account only the amount paid by CIT for the long, or purchased, option, and

not the amount CIT received for the short, or sold, option. *Id.* ¶ 13a-c. According to Daugerdas, when CIP was liquidated, the adjusted basis of the long option was assigned by operation of law to the [euro] 55,947.19 in euros CIP had purchased on December 18, 2000, giving the [*6] euros an adjusted basis of $ 3,614,536.29.[4] *Id.* ¶ 13d. The adjusted basis was then carried forward to Cemco when CIT contributed the euros to Cemco on December 26, 2000. *Id.* ¶ 13e. Thus, according to Daugerdas, Cemco's sale of the euros—which had an adjusted basis of $ 3,614,536.29—for $ 51,324.58 on December 29, 2000, resulted in a loss of $ 3,563,211.71 to Cemco. *Id.* ¶ 13.

On September 21, 2004, the IRS issued the FPAA from which this case arises to Forest, Cemco's tax matters partner. In the FPAA, the IRS

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[4] CIP's year 2000 Form 1065 tax return of partnership income reported distributions of property totally $ 3,661,383. Cemco asserts that the total adjusted basis of CIP's assets at the time of liquidation, taking into account the value of the long option, was approximately $ 3,660,383. According to Cemco, the euros were assigned a basis of $ 3,614,536.29 "as a residual matter" under I.R.C. § 732 (2006) because CIP's assets consisted only of $45,847.27 and the euros. Pl.'a Mem. Supp. Mot. Summ. J. 4 n.4. The court notes that the parties' numbers do not perfectly match up, but exact numerical computation is not necessary for the court to rule upon the legal issues raised in the parties' motions.

determined that Cemco "was a sham, lacked economic substance, or, under § 1.701-2 of the Income Tax Regulations, was formed or availed of in connection with a transaction or transactions in taxable year 2000, a principal purpose of which was to reduce substantially the present value of its partners' aggregate tax liability"--in other words, that Cemco was an illegal tax shelter and would not be regarded as a partnership for tax purposes. Decl. Paul M. Daugerdas Ex. A. The FPAA disallowed both Cemco's claimed loss of $ 3,563,211.71 and its claimed capital contributions of $ 5,144,536, reducing both partnership items to zero. The FPAA also assessed four separate accuracy-related penalties pursuant to I.R.C. § 6662 (2006): a twenty-percent penalty for negligence, a twenty-percent penalty for substantial underpayment of tax, a twenty-percent penalty for substantial valuation misstatement, and a forty-percent penalty for gross valuation misstatement. While the FPAA adjusted Cemco's year 2000 return, the IRS did not issue a similar FPAA to CIP.

On December 20, 2004, Cemco filed its petition seeking judicial review of the FPAA with this court. Cemco has since amended its petition twice with the court's permission. In its second amended petition, Cemco challenges the adjustments the FPAA made to Cemco's partnership items--i.e., the disallowance of Cemco's claimed capital contributions of $ 5,114,536 and the disallowance of Cemco's claimed loss of $ 3,563,211.71--as well as all of the accuracy-related penalties imposed by the FPAA. The portions of Cemco's second amended petition at issue in the parties' summary judgment motions are those

challenging the disallowance of the $ 3,563,211.71 loss and the penalties for gross valuation misstatement and substantial valuation misstatement. *See* Second Am. Pet. ¶¶ 6b-6d.

II. ANALYSIS

Summary judgment is appropriate when "the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c). As noted above, none of the facts material to either party's motion for summary judgment are in dispute; the parties agree as to the underlying events upon which the FPAA is based. The parties do disagree vehemently, however, about the tax consequences that should flow from the relevant events. Each party has moved for summary judgment on the same two aspects of Cemco's second amended petition: (1) Cemco's challenge to the FPAA's disallowance of Cemco's claimed loss of $ 3,563,211.71; and (2) Cemco's challenge to the FPAA's imposition of accuracy-related penalties for substantial valuation misstatement and gross valuation misstatement. The court considers the parties' arguments with respect to each portion of Cemco's second amended petition in turn.

A. Cemco's Claimed Loss of $ 3,563,211.71

Before the court considers the parties' disagreements regarding Cemco's claimed loss, it is important to highlight one point upon which they

agree: the loss of $ 3,563,211.71 claimed on Cemco's year 2000 return was fictional. Of course, Cemco did not *actually* suffer a loss of $ 3,563,211.71 when it sold the euros because the euros were purchased for only $ 50,000 (by CIP) and the adjusted basis assigned to them by CIP (and carried forward to Cemco) did not take into account that CIT received $ 3,564,000 from the sale of the digital foreign currency option at the same time CIT purchased it. Cemco's argument for overturning the FPAA is not that it truly suffered a loss of $ 3,563,211.71, but that it was required to report such a loss because CIP determined that the euros had an adjusted basis of $ 3,614,536.29. At the outset, however, the court notes that it is undisputed that CIP's determination of the adjusted basis of the euros was premised on an outdated interpretation of I.R.C. § 752 (2006), the section dealing with the treatment of liabilities by partners and partnerships.

Until recently, the law respecting whether an option contract should be treated as a liability under section 752 actually supported CIP's position. In *Helmer v. Commissioner,* T.C. Memo 1975-160, 34 T.C.M. (CCH) 727 (1975), the Tax Court held that a contingent obligation, such as a short or sold option, is not a liability under section 752 because a partnership's obligation under the option does not become fixed until the option is exercised. This principle was affirmed in multiple subsequent cases under section 752. *See, e.g., Long v. Comm'r,* 71 T.C. 1, 6-7 (1978), *aff'd in part,* 660 F.2d 416 (10th Cir. 1981) (holding that contingent obligations are not liabilities for purposes of increasing partnership basis until they become fixed or liquidated); *La Rue*

v. Comm'r, 90 T.C. 465, 478 (1988) (obligations that are fixed but remain contingent are not liabilities under section 752); *Gibson Prods. Co. v. United States*, 637 F.2d 1041, 1049 (5th Cir. 1981) (contingent nature of a partnership obligation precludes treatment as a liability for tax purposes). For many years, the *Helmer* rule served as the definition of liability under section 752. *See* Assumption of Partnership Liabilities, 68 Fed. Reg. 37434 (June 24, 2003) ("There is no statutory or regulatory definition of liabilities for purposes of section 752."). Thus, under *Helmer* and its progeny, it would have been proper for CIP to ignore the short, or sold, option as a liability under section 752.

Shortly before the transactions underlying this case occurred, however, the IRS reversed its position regarding partnershipliabilities under section 752, promulgating regulations designed to disallow losses such as those claimed by CIP and Cemco. On August 13, 2000, the IRS released IRS Notice 2000-44, 2000-2 C.B. 255 (the "Notice"); the Notice was published on September 5, 2000. In the Notice, the IRS discussed certain types of transactions designed to generate tax losses by "using [an] artificially high basis," and explained that such losses were not allowable and could result in penalties for taxpayers. *Id.* The Notice gave the following example of such a scheme:

> [A] taxpayer purchases and writes options and purports to create substantial positive basis in a partnership interest by transferring those option positions to a partnership. For example, a taxpayer might

purchase call options for a cost of $ 1,000X and simultaneously write offsetting call options, with a slightly higher strike price but the same expiration date, for a premium of slightly less than $ 1,000X. Those option positions are then transferred to a partnership which, using additional amounts contributed to the partnership, may engage in investment activities.

Under the position advanced by the promoters of this arrangement, the taxpayer claims that the basis in the taxpayer's partnership interest is increased by the cost of the purchased call options but is not reduced under § 752 as a result of the partnership's assumption of the taxpayer's obligation with respect to the written call options. Therefore, disregarding additional amounts contributed to the partnership, transaction costs, and any income realized and expenses incurred at the partnership level, the taxpayer purports to have a basis in the partnership interest equal to the cost of the purchased call options ($ 1,000X in this example), even though the taxpayer's net economic outlay to acquire the partnership interest and the value of the partnership interest are nominal or zero. On the disposition of the partnership interest, the taxpayer claims a tax loss ($ 1,000X in this example), even though the taxpayer has incurred no corresponding economic loss.

Id. The Notice further stated that purported losses resulting from "arrangements designed to produce noneconomic tax losses by artificially overstating basis in partnership interests" are not "bona fide losses" and therefore "are not allowable as deductions for federal income tax purposes." *Id.* In addition, the Notice stated that "the transactions may be subject to challenge under § 752, or under § 1.701-2 or other anti-abuse rules," and could result in penalties such as "the accuracy-related penalty under § 6662." *Id.*

In addition to the Notice, the Treasury Department published new regulations pertaining to section 752 on June 24, 2003. The new regulations altered the definition of liability under section 752 to include "any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Internal Revenue Code." Treas. Reg. § 1.752-1(a)(4)(ii) (2003). Under this definition, "[o]bligations include . . . obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, and futures contracts." 68 Fed. Reg. 37434, Explanation of Provisions. Thus, "[t]he definition of liability contained in the[] . . . regulations does *not* follow *Helmer v. Commissioner*." *Id.* (emphasis added). The Treasury Department made the new definition of partnership liabilities retroactively applicable to assumptions of liability by partnerships between

October 18, 1999, and June 24, 2003.[5] *See* Temp. Treas. Reg. § 1.752-6T(d) (2003); Treas. Reg. § 1.752-6(d) (2003). Importantly, Treas. Reg. § 1.752-6 specifically refers to the transactions described in the Notice as obligations that must be taken into account by partnerships in determining liabilities under section 752. Treas. Reg. § 1.752-6(b)(2).

In its opening brief, Cemco states that "[t]he return positions taken by CIP and [Cemco] did not take the sold option into account because of the rule of *Helmer*." Pet. Mem. Supp. Summ. J. 11. Cemco acknowledges that Treas. Reg. § 1.752-6 reverses *Helmer* and requires "that these types of potential obligations [i.e., the short option] must be taken into account as liabilities in computing the basis of property contributed to a partnership." *Id.* at 12; *see also* Decl. Paul M. Daugerdas ¶ 14 ("If the rule respecting the treatment of liabilities set out in Treas. Reg. § 1.752-6T (June 2003) and Treas. Reg. § 1.752-6 (May 2005) is (retroactively) applied to [Cemco's] tax return for 2000 and that application is proper, the ordinary loss of $ 3,563,211.71 claimed on the return would be disallowed as determined by the IRS's FPAA."). Thus, there is no dispute regarding whether the calculations regarding the adjusted basis of the euros made by CIP and carried forward to Cemco were correct--under the regulatory regime described above, they clearly were not.

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[5] Assumptions of liabilities by partnerships occurring after June 24, 2003, are governed by Treas. Reg. § 1.752-7 (2005).

While Cemco does not argue that CIP's calculations were correct, it does disagree with the course of action taken by the IRS. Cemco's primary argument in support of its motion for summary judgment is that the IRS issued the FPAA to the wrong party. Cemco notes that the FPAA's disallowance of Cemco's claimed loss is premised on the IRS' position that the adjusted basis of the euros was miscalculated. According to Cemco, however, the fault for the euros' overstated basis lies with CIP because CIP is the party that failed to take the short option into account. Cemco also contends that the I.R.C. required it to assign the same adjusted basis to the euros as did CIP when the euros were contributed to Cemco. As a result, Cemco asserts, the IRS was required to issue a FPAA to CIP if it wished to alter the adjusted basis of the euros, and the IRS' failure to do so conclusively establishes the adjusted basis of the euros at $ 3,614,536.29. As detailed below, Cemco's theory consists of several nuanced procedural steps. Ultimately, however, the argument amounts to little more than a house of cards, for if any of the steps fail (and several do), Cemco's entire position collapses.

The first step in Cemco's line of reasoning involves the adjusted basis of the euros in the hands of CIP. Cemco contends that CIP assigned the euros an adjusted basis of $ 3,614,536,29 when CIP was liquidated because "the total tax basis of the CIP assets at the time of liquidation [was] $ 3,660,383" and CIP's only asset besides the euros was $ 45,847.27 in cash. Pet.'s Mem. Supp. Mot. Summ. J. 4 n.4. Cemco argues that CIP was required to assign the euros this adjusted basis as a residual

matter under I.R.C. §§ 732 and 988, which provide rules for allocating basis among partnership property and for computing gain or loss on foreign currency, respectively. This argument, however, presupposes that CIP had a basis of $ 3,600,000 in the long option to begin with. But, as noted above, CIP could not have had such a basis because § 752 and Treas. Reg. § 1.752-6 required CIP to account for the short option as a liability in determining the adjusted basis of its assets, a point which Cemco concedes.[6] [6] Accordingly, the first link in Cemco's theory fails because the total tax basis of CIP's assets was *not* $ 3,660,383, and CIP was *not* required to assign the euros an adjusted basis of anything approaching $ 3,614,536.29.

Undeterred, Cemco points out that CIP *did* assign the euros an adjusted basis of $ 3,614,536.29, even if it was not supposed to. According to Cemco, CIP's determination with regard to the euros is important because Cemco was required to assign the euros the same adjusted basis when they were contributed to Cemco. Cemco cobbles together several different I.R.C. and regulatory provisions to support this argument. First, Cemco points to I.R.C. § 723, which provides, in relevant part: "The basis of property contributed to a partnership by a partner shall be the adjusted basis of such property to the

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[6] Cemco raises no argument regarding the propriety of applying I.R.C. § 752 (2006) or Treas. Reg. § 1.752-6 (2003) to CIP's computation of the adjusted basis of the euros, but instead argues that CIP's mistake should be isolated to CIP.

contributing partner at the time of the contribution . . . ." Cemco contends that section 723 mandates that the euros be assigned an adjusted basis of $ 3,614,536.29 in the hands of Cemco. While section 723 states that a partnership's basis in contributed property should correspond to the adjusted basis of the property to the contributing partner, it does *not* state that a partnership is relieved from properly calculating the partner's adjusted basis in order to determine the partnership's basis in the contributed property, a distinction that is important for reasons that will be explained shortly.

Cemco expands upon its argument under section 723 by pointing to the unified partnership audit and litigation rules provided by the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 402, 96 Stat. 324, 648-671 (codified as amended at I.R.C. §§ 6221-6234 (2006)) ("TEFRA"). Under TEFRA, "the tax treatment of any partnership item (and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item) shall be determined at the partnership level." I.R.C. § 6221. The I.R.C. defines "partnership item" as "any item required to be taken into account for the partnership's taxable year . . . to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level." I.R.C. § 6231. As the United States Court of Appeals for the Seventh Circuit has noted, this is "a rather tautological definition," which does little more than point to the regulations. *Kaplan v. United States*, 133 F.3d 469, 473 (1998). In this case, however, there is no dispute

between Cemco and respondent as to whether the determinations relevant to this case are partnership items under the relevant Treasury regulations.

Under Treas. Reg. § 301.6231(a)(3)-1 (as amended in 1986), items relating to contributions to a partnership and distributions from a partnership are partnership items "to the extent that a determination of such items can be made from determinations that the partnership is required to make." *Id.* § 301.6231(a)(3)-1(a)(4). The regulation provides that "[t]he basis to the partnership of contributed property" and "[t]he adjusted basis to the partnership of distributed property" are determinations the partnership is required to make with respect to contributions and distributions, respectively. *Id.* § 301.6231(a)(3)-1(c)(2)(iv), (c)(3)(iv). Cemco points out that, under this regulation, CIP was required to determine the basis of the options contributed to it by CIT and the adjusted basis of its assets when it distributed them upon liquidation. To properly make this determination, CIP needed only to "apply Treas. Reg. § 1.752-6T (or, subsequently, its successor, Treas. Reg. § 1.752-6) to the options that were contributed to CIP on December 5, 2000. No further information [was] needed to determine the adjusted basis of the [e]uros." Pet. Mem. Supp. Summ. J. 7. Thus, because the adjusted basis of the euros can be determined from determinations CIP was required to (but did not properly) make, the adjusted basis of the euros is a partnership item of CIP. *See* Treas. Reg. § 301.6231(a)(3)-1(a)(4). Because the adjusted basis of the euros is a partnership item of CIP, Cemco argues, the IRS should have issued a FPAA to CIP if it wanted to

alter the euros' tax treatment rather than proceeding against Cemco.

Respondent agrees with Cemco that the adjusted basis of the euros is a partnership item of CIP under the regulations. Resp. Mem. Opp'n Pet. Mot. Summ J. 3. However, respondent argues that the adjusted basis of the euros is *also* a partnership item of Cemco, and therefore the IRS could challenge the claimed basis of the euros by issuing a FPAA to *either* CIP *or* Cemco. *Id.* Respondent is correct. As noted above, items relating to contributions to a partnership are partnership items to the extent they can be determined from determinations the partnership is required to make. Treas. Reg. § 301.6231(a)(3)-1(4)(i). Under the regulations, a partnership is required to determine "[t]he basis to the partnership of contributed property (*including necessary preliminary determinations, such as the partner's basis in the contributed property*). *Id.* § 301.6231(a)(3)-1(c)(2)(iv) (emphasis added). Moreover, "[t]he term 'partnership item' includes the accounting practices *and the legal and factual determinations* that underlie the determination of amount, timing, and characteristics of items of income, credit, gain, loss, deduction, etc." *Id.* § 301.6231(a)(3)-1(b) (emphasis added). "The critical element is that the partnership needs to make a determination with respect to a matter for the purposes stated; failure by the partnership actually to make a determination . . . does not prevent an item from being a partnership item." *Id.* § 301.6231(a)(3)-1(c)(1).

Under the above regulations, Cemco was required to correctly determine the basis of the euros contributed to it; Cemco could not simply carry over whatever basis the euros had been assigned by CIT or CIP under § 723, as it contends. Because Cemco was required to make this determination, the adjusted basis of the euros is a partnership item of Cemco. This partnership item includes the legal determinations (such as whether the short option was a liability) that underlie the adjusted basis of the euros. Therefore, the FPAA issued to Cemco is not premised on CIP's failures, as Cemco asserts. Rather, it is based on Cemco's failure to properly determine the basis of the euros contributed to it, which it was required to do under Treas. Reg. § 301.6231(a)(3)-1.

The remainder of the provisions cited by Cemco likewise do not support its argument that it was required to report the basis of the euros consistently with CIP. Cemco points to Treas. Reg. § 301.6222(a)-1T (1987) and Treas. Reg. § 301.6222(a)-2T (1987), neither of which is applicable. Under the former, a partnership item is required to be treated on a partner's tax return consistently with the manner in which it is treated on the partnership's return. *See* Treas. Reg. § 301.6222(a)-1T(a). However, as pointed out by respondent, Cemco is not a partner in CIP, so this rule does not apply.

The same result follows with respect to Treas. Reg. § 301.6222(a)-2T, which requires an "indirect partner" to treat partnership items from a "source partnership" consistently with the manner in which the source partnership has treated them. *Id.*

§ 301.6222(a)-2T(a)-(b). A "source partnership" is the partnership "from which the partnership item originates." *Id.* § 301.6222(a)-2T(a). Cemco contends that it was required to report the adjusted basis of the euros consistently with CIP because the adjusted basis originated with CIP. The problem, however, is that Cemco is not an indirect partner of CIP. An indirect partner is "a person holding an interest in a partnership through 1 or more pass-thru partners." I.R.C. § 6231(a)(10). A pass-thru partner, in turn, is "a partnership, estate, trust, S corporation, nominee, or other similar person through whom other persons hold an interest in the partnership." *Id.* § 6231(a)(9). Cemco did not hold an indirect interest in CIP, and so the consistent reporting provisions of Treas. Reg. § 301.6222(a)-2T do not apply.

Because the adjusted basis of the euros is a partnership item of Cemco, and because Cemco was not compelled to report the euros consistently with CIP, Cemco's argument that the IRS was required to proceed against CIP is erroneous. Cemco cites to Treas. Reg. § 301.6221-1T (1999) (temporary regulation applicable to partnership taxable years prior to October 4, 2001), which provides that the IRS generally cannot adjust the tax treatment of an item on a partner's return unless it first proceeds against the partnership. *See* Treas. Reg. § 301.6221-1T(a) (1999) *see also id.* § 301.6221-1T(c) (noting that adjustments related to partnership items "shall be made based on partnership level determinations. Partnership level determinations include all the legal and factual determinations that underlie the determination of any penalty, addition to tax, or additional amount . . . ."). But Cemco was not a

partner of CIP, so the IRS was entitled to challenge the adjusted basis of the euros--which is the foundation upon which Cemco's claimed loss of $ 3,563,211.71 is built--in a FPAA issued to Cemco.[7] *See* I.R.C. § 6221. Therefore, Cemco's argument that the adjusted basis of the euros is conclusively established at $ 3,614,536.29 because the IRS did not challenge CIP's determination by way of an FPAA issued to CIP must fail. Accordingly, respondent's motion for summary judgment as to paragraph 6d of Cemco's second amended petition is granted and Cemco's motion for summary judgment on that same paragraph is denied.

B. The Valuation Misstatement Penalties

The second portion of Cemco's second amended petition at issue is the portion challenging the valuation misstatement penalties. Pursuant to I.R.C. § 6662 (2006), an accuracy-related penalty is imposed on certain underpayments of tax. *Id.* § 6662(a). Section 6662 imposes a penalty of twenty percent on the portion of an underpayment that is due to a "substantial valuation misstatement," and a penalty of forty percent on the portion that is due to a "gross valuation misstatement." *Id.* § 6662(e), (h). The penalties contained in section 6662 may not be compounded--that is, the percentages cannot be added, even if the portion of an underpayment at

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[7] Cemco's argument that the penalties imposed by the FPAA are improper because they are based on events that occurred at CIP is rejected for this same reason. See Treas. Reg. § 301.6221-1T(c) (1999).

issue is attributable to more than one type of accuracy-related misconduct. *See* Treas. Reg. § 1.6662-2(c) (as amended in 2003).

Under section 6662, a substantial valuation misstatement occurs when "the value of any property (or the adjusted basis of any property) claimed on any return of tax . . . is 200 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be)." I.R.C. § 6662(e)(1)(A). In addition, the portion of the underpayment of tax attributable to the substantial valuation misstatement must exceed $ 5,000. *Id.* § 6662(e)(2). The definition of gross valuation misstatement is the same, except, *inter alia*, the penalty is increased to forty percent and the amount claimed on the tax return must be 400 percent or greater of the amount determined to be the correct value or adjusted basis. *Id.* § 6662(h)(2).

Cemco's second amended petition challenges the valuation misstatement penalties on the basis that the underpayment of tax alleged in the FPAA is not attributable to a misstatement of value. Second Am. Pet. ¶¶ 6b-6c. In support of its motion for summary judgment, Cemco elaborates on this theory, arguing that there is no dispute over the value of the options. According to Cemco, "there is only a dispute over whether the applicable legal rule requires a sold (or 'short') option to be taken into account in determining the *adjusted basis* of the distributed and contributed property." Pet. Mem. Supp. Summ. J. 10. Because the underpayment of tax does not result from an incorrect valuation, Cemco contends,

a valuation misstatement penalty cannot be imposed as a matter of law.

In order for Cemco to prevail on this theory, it must overcome the clear statutory language of section 6662, which, as demonstrated above, states that valuation misstatements include highly inflated adjusted bases. I.R.C. § 6662(e)(1)(A). To do so, Cemco asks the court to find import in the parentheses placed around the words "adjusted basis" the first time they appear in the statute. *Id.* Cemco points to the legislative history of the predecessor to section 6662, I.R.C. § 6659 (2006), *repealed by* Omnibus Budget Reconciliation Act of 1989, Pub. L. 101-239, 103 Stat. 2106, noting that the legislative history to the earlier section demonstrates that it was primarily enacted to deal with problems related to the valuation of property. Cemco argues that section 6659 did not contain parentheses around the words "adjusted basis," and suggests that their addition in section 6662 relegated that phrase to a merely illustrative or clarifying rule. According to Cemco, a misstatement of "adjusted basis" should be punishable under section 6662 only if a misstatement of value "is embedded in a misstatement of adjusted basis." Pet. Mem. Supp. Summ. J. 15. In other words, Cemco contends that value must be "a predicate for determining the adjusted basis of property" for the valuation misstatement penalty to apply to a misstatement of adjusted basis under section 6662. *Id.*

While Cemco makes a valiant effort to overcome the language of section 6662, it has included nothing

in its briefs to indicate an interpretation such as it describes was intended. It is worth pointing out that the text of section 6659 was very similar to that currently contained in section 6662: "there is a valuation overstatement if the value of any property, or the adjusted basis of any property, claimed on any return exceeds 150 percent of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be)." I.R.C. § 6659. Cemco has presented no materials indicating why the parentheses were added in section 6662, and the court is unwilling to read adjusted basis out of the statute, as Cemco asks, absent a clear indication.[8] As respondent points out, other courts have likewise been unwilling to do so. *See, e.g., Santa Monica Pictures, LLC v. Comm'r,* T.C. Memo 2005-104, 89 T.C.M. (CCH) 1157 (2005) (finding that Congress specifically included underpayments of tax due to inflated adjusted basis in the definition of "valuation misstatement"). Accordingly, Cemco's motion for summary judgment as to paragraphs 6b and 6c of its second amended petition is denied. As the valuation argument

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[8] Cemco points to Chickasaw Nation v. United States, 534 U.S. 84, 89, 122 S. Ct. 528, 151 L. Ed. 2d 474 (2001), where the United States Supreme Court determined that a parenthetical phrase which was in conflict with the Congressional intention apparent in the natural language of the words outside the parentheses was merely illustrative of the words outside of the parentheses. In contrast with Chickasaw Nation, however, the words "adjusted basis" found inside the parentheses in I.R.C. § 6662(e)(1)(A) (2006) do not conflict with the language outside the parentheses.

outlined above is the only contention regarding the valuation penalties raised in Cemco's second amended petition, respondent's motion for summary judgment as to paragraphs 6b and 6c is granted. As there is no dispute that the adjusted basis of the euros reported by Cemco on its year 2000 tax return is 400 percent or more greater than the amount determined by the IRS to be the correct basis, I.R.C. § 6662(h)(2), a penalty of forty percent will apply to the portion of Cemco's underpayment of tax attributable to Cemco's gross valuation misstatement, *see* Treas. Reg. § 1.6662-2(c).

III. CONCLUSION

For the foregoing reasons, Cemco's motion for summary judgment is denied and respondent's motion for summary judgment is granted. The parties are ordered to appear before the court on the date stated in the attached minute order to inform the court regarding what additional steps, if any, must be taken in this case.

Joan B. Gottschall

United States District Judge

DATED: March 27, 2007

APPENDIX C
Relevant Statutory Provisions

26 U.S.C. § 752

§ 752. Treatment of certain liabilities.

(a) Increase in partner's liabilities. Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

(b) Decrease in partner's liabilities. Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

(c) Liability to which property is subject. For purposes of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property.

(d) Sale or exchange of an interest. In the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.

26 U.S.C. § 6662

§ 6662. Imposition of accuracy-related penalty on underpayments.

(a) Imposition of penalty. If this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies.

(b) Portion of underpayment to which section applies. This section shall apply to the portion of any underpayment which is attributable to 1 or more of the following:

(1) Negligence or disregard of rules or regulations.

(2) Any substantial understatement of income tax.

(3) Any substantial valuation misstatement under chapter 1 [26 USCS §§ 1 et seq.].

(4) Any substantial overstatement of pension liabilities.

(5) Any substantial estate or gift tax valuation understatement.

This section shall not apply to any portion of an underpayment on which a penalty is imposed under section 6663 [26 USCS § 6663]. Except as provided in paragraph (1) or (2)(B) of section 6662A(e) [26 USCS § 6662A(e)], this section shall not apply to the

portion of any underpayment which is attributable to a reportable transaction understatement on which a penalty is imposed under section 6662A [26 USCS § 6662A].

(c) Negligence. For purposes of this section, the term "negligence" includes any failure to make a reasonable attempt to comply with the provisions of this title, and the term 'disregard' includes any careless, reckless, or intentional disregard.

(d) Substantial understatement of income tax.

(1) Substantial understatement.—

(A) In general. For purposes of this section, there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of—

(i) 10 percent of the tax required to be shown on the return for the taxable year, or

(ii) $ 5,000.

(B) Special rule for corporations. In the case of a corporation other than an S corporation or a personal holding company (as defined in section 542 [26 USCS § 542]), there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the lesser of—

(i) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, $ 10,000), or

(ii) $ 10,000,000.

(2) Understatement.

(A) In general. For purposes of paragraph (1), the term 'understatement' means the excess of—

(i) the amount of the tax required to be shown on the return for the taxable year, over

(ii) the amount of the tax imposed which is shown on the return, reduced by any rebate (within the meaning of section 6211(b)(2) [26 USCS § 6211(b)(2)]).

The excess under the preceding sentence shall be determined without regard to items to which section 6662A [26 USCS § 6662A] applies.

(B) Reduction for understatement due to position of taxpayer or disclosed item. The amount of the understatement under subparagraph (A) shall be reduced by that portion of the understatement which is attributable to—

(i) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or

(ii) any item if—

(I) the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return, and

(II) there is a reasonable basis for the tax treatment of such item by the taxpayer.

For purposes of clause (ii)(II), in no event shall a corporation be treated as having a reasonable basis for its tax treatment of an item attributable to a multiple-party financing transaction if such treatment does not clearly reflect the income of the corporation.

(C) Reduction not to apply to tax shelters.

(i) In general. Subparagraph (B) shall not apply to any item attributable to a tax shelter.

(ii) Tax shelter. For purposes of clause (i), the term "tax shelter" means—

(I) a partnership or other entity,

(II) any investment plan or arrangement, or

(III) any other plan or arrangement,

if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.

(3) Secretarial list. The Secretary may prescribe a list of positions which the Secretary believes do not meet 1 or more of the standards specified in

paragraph (2)(B)(i), section 6664(d)(2) [26 USCS § 6664(d)(2)], and section 6694(a)(1) [26 USCS § 6694(a)(1)]. Such list (and any revisions thereof) shall be published in the Federal Register or the Internal Revenue Bulletin.

(e) Substantial valuation misstatement under chapter 1.

(1) In general. For purposes of this section, there is a substantial valuation misstatement under chapter 1 [26 USCS §§ 1 et seq.] if—

(A) the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter 1 [26 USCS §§ 1 et seq.] is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be), or

(B) (i) the price for any property or services (or for the use of property) claimed on any such return in connection with any transaction between persons described in section 482 [26 USCS § 482] is 200 percent or more (or 50 percent or less) of the amount determined under section 482 [26 USCS § 482] to be the correct amount of such price, or

(ii) the net section 482 [26 USCS § 482] transfer price adjustment for the taxable year exceeds the lesser of $ 5,000,000 or 10 percent of the taxpayer's gross receipts.

(2) Limitation. No penalty shall be imposed by reason of subsection (b)(3) unless the portion of the underpayment for the taxable year attributable to

substantial valuation misstatements under chapter 1 [26 USCS §§ 1 et seq.] exceeds $ 5,000 ($ 10,000 in the case of a corporation other than an S corporation or a personal holding company (as defined in section 542) [26 USCS § 542]).

(3) Net section 482 transfer price adjustment. For purposes of this subsection—

(A) In general. The term 'net section 482 transfer price adjustment' means, with respect to any taxable year, the net increase in taxable income for the taxable year (determined without regard to any amount carried to such taxable year from another taxable year) resulting from adjustments under section 482 [26 USCS § 482] in the price for any property or services (or for the use of property).

(B) Certain adjustments excluded in determining threshold. For purposes of determining whether the threshold requirements of paragraph (1)(B)(ii) are met, the following shall be excluded:

(i) Any portion of the net increase in taxable income referred to in subparagraph (A) which is attributable to any redetermination of a price if—

(I) it is established that the taxpayer determined such price in accordance with a specific pricing method set forth in the regulations prescribed under section 482 [26 USCS § 482] and that the taxpayer's use of such method was reasonable,

(II) the taxpayer has documentation (which was in existence as of the time of filing the return)

which sets forth the determination of such price in accordance with such a method and which establishes that the use of such method was reasonable, and

(III) the taxpayer provides such documentation to the Secretary within 30 days of a request for such documentation.

(ii) Any portion of the net increase in taxable income referred to in subparagraph (A) which is attributable to a redetermination of price where such price was not determined in accordance with such a specific pricing method if—

(I) the taxpayer establishes that none of such pricing methods was likely to result in a price that would clearly reflect income, the taxpayer used another pricing method to determine such price, and such other pricing method was likely to result in a price that would clearly reflect income,

(II) the taxpayer has documentation (which was in existence as of the time of filing the return) which sets forth the determination of such price in accordance with such other method and which establishes that the requirements of subclause (I) were satisfied, and

(III) the taxpayer provides such documentation to the Secretary within 30 days of request for such documentation.

(iii) Any portion of such net increase which is attributable to any transaction solely between foreign corporations unless, in the case of any such

corporations, the treatment of such transaction affects the determination of income from sources within the United States or taxable income effectively connected with the conduct of a trade or business within the United States.

(C) Special rule. If the regular tax (as defined in section 55(c) [26 USCS § 55(c)]) imposed by chapter 1 [26 USCS §§ 1 et seq.] on the taxpayer is determined by reference to an amount other than taxable income, such amount shall be treated as the taxable income of such taxpayer for purposes of this paragraph.

(D) Coordination with reasonable cause exception. For purposes of section 6664(c) [26 USCS § 6664(c)] the taxpayer shall not be treated as having reasonable cause for any portion of an underpayment attributable to a net section 482 transfer price adjustment unless such taxpayer meets the requirements of clause (i), (ii), or (iii) of subparagraph (B) with respect to such portion.

(f) Substantial overstatement of pension liabilities.

(1) In general. For purposes of this section, there is a substantial overstatement of pension liabilities if the actuarial determination of the liabilities taken into account for purposes of computing the deduction under paragraph (1) or (2) of section 404(a) [26 USCS § 404(a)] is 200 percent or more of the amount determined to be the correct amount of such liabilities.

(2) Limitation. No penalty shall be imposed by reason of subsection (b)(4) unless the portion of the

underpayment for the taxable year attributable to substantial overstatements of pension liabilities exceeds $ 1,000.

(g) Substantial estate or gift tax valuation understatement.

(1) In general. For purposes of this section, there is a substantial estate or gift tax valuation understatement if the value of any property claimed on any return of tax imposed by subtitle B [26 USCS §§ 2001 et seq.] is 65 percent or less of the amount determined to be the correct amount of such valuation.

(2) Limitation. No penalty shall be imposed by reason of subsection (b)(5) unless the portion of the underpayment attributable to substantial estate or gift tax valuation understatements for the taxable period (or, in the case of the tax imposed by chapter 11 [26 USCS §§ 2001 et seq.], with respect to the estate of the decedent) exceeds $ 5,000.

(h) Increase in penalty in case of gross valuation misstatements.

(1) In general. To the extent that a portion of the underpayment to which this section applies is attributable to one or more gross valuation misstatements, subsection (a) shall be applied with respect to such portion by substituting '40 percent' for '20 percent'.

(2) Gross valuation misstatements. The term 'gross valuation misstatements' means—

(A) any substantial valuation misstatement under chapter 1 [26 USCS §§ 1 et seq.] as determined under subsection (e) by substituting—

(i) in paragraph (1)(A), "200 percent" for "150 percent",

(ii) in paragraph (1)(B)(i)—

(I) "400 percent" for "200 percent", and

(II) "25 percent" for "50 percent", and

(iii) in paragraph (1)(B)(ii)—

(I) "$ 20,000,000" for "$ 5,000,000", and

(II) "20 percent" for "10 percent".

(B) any substantial overstatement of pension liabilities as determined under subsection (f) by substituting "400 percent" for "200 percent", and

(C) any substantial estate or gift tax valuation understatement as determined under subsection (g) by substituting "40 percent" for "65 percent".

APPENDIX D
Relevant Regulatory Sections

26 C.F.R. § 1.752-6

§ 1.752-6 Partnership assumption of. partner's section 358(h)(3) [26 USCS § 358(h)(3)] liability after October 18, 1999, and before June 24, 2003.

(a) In general. If, in a transaction described in section 721(a) [26 USCS § 721(a)], a partnership assumes a liability (defined in section 358(h)(3) [26 USCS § 358(h)(3)]) of a partner (other than a liability to which section 752(a) and (b) [26 USCS § 752(a) and (b)] apply), then, after application of section 752(a) and (b) [26 USCS § 752(a) and (b)], the partner's basis in the partnership is reduced (but not below the adjusted value of such interest) by the amount (determined as of the date of the exchange) of the liability. For purposes of this section, the adjusted value of a partner's interest in a partnership is the fair market value of that interest increased by the partner's share of partnership liabilities under §§ 1.752-1 through 1.752-5.

(b) Exceptions –

(1) In general. Except as provided in paragraph (b)(2) of this section, the exceptions contained in section 358(h)(2)(A) and (B) [26 USCS § 358(h)(2)(A) and (B)] apply to this section.

(2) Transactions described in Notice 2000-44. The exception contained in section 358(h)(2)(B) [26 USCS § 358(h)(2)(B)] does not apply to an assumption of a liability (defined in section 358(h)(3) [26 USCS

§ 358(h)(3)]) by a partnership as part of a transaction described in, or a transaction that is substantially similar to the transactions described in, Notice 2000-44 (2000-2 C.B. 255). See § 601.601(d)(2) of this chapter.

(c) Example. The following example illustrates the principles of paragraph (a) of this section:

Example. In 1999, A and B form partnership PRS. A contributes property with a value and basis of $ 200, subject to a nonrecourse debt obligation of $ 50 and a fixed or contingent obligation of $ 100 that is not a liability to which section 752(a) and (b) [26 USCS § 752(a) and (b)] applies, in exchange for a 50% interest in PRS. Assume that, after the contribution, A's share of partnership liabilities under §§ 1.752-1 through 1.752-5 is $ 25. Also assume that the $ 100 liability is not associated with a trade or business contributed by A to PRS or with assets contributed by A to PRS. After the contribution, A's basis in PRS is $ 175 (A's basis in the contributed land ($ 200) reduced by the nonrecourse debt assumed by PRS ($ 50), increased by A's share of partnership liabilities under §§ 1.752-1 through 1.752-5 ($ 25)). Because A's basis in the PRS interest is greater than the adjusted value of A's interest, $ 75 (the fair market value of A's interest ($ 50) increased by A's share of partnership liabilities ($ 25)), paragraph (a) of this section operates to reduce A's basis in the PRS interest (but not below the adjusted value of that interest) by the amount of liabilities described in section 358(h)(3) [26 USCS § 358(h)(3)] (other than liabilities to which section 752(a) and (b) [26

USCS § 752(a) and (b)] apply) assumed by PRS. Therefore, A's basis in PRS is reduced to $ 75.

(d) Effective date—

(1) In general. This section applies to assumptions of liabilities occurring after October 18, 1999, and before June 24, 2003.

(2) Election to apply § 1.752-7. The partnership may elect, under § 1.752-7(k)(2), to apply the provisions referenced in § 1.752-7(k)(2)(ii) to all assumptions of liabilities by the partnership occurring after October 18, 1999, and before June 24, 2003. Section 1.752-7(k)(2) describes the manner in which the election is made.

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(3)

No. 07-1526

FILED
AUG 7 - 2008
OFFICE OF THE CLERK
SUPREME COURT, U.S.

In the Supreme Court of the United States

CEMCO INVESTORS, LLC, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

GREGORY G. GARRE
Acting Solicitor General
Counsel of Record
GILBERT S. ROTHENBERG
Acting Assistant Attorney General
RICHARD FARBER
ARTHUR T. CATTERALL
Attorneys
Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

QUESTIONS PRESENTED

1. Whether the court of appeals correctly held that 26 C.F.R. 1.752-6 applies retroactively to petitioners' transactions.

2. Whether the court of appeals correctly rejected petitioners' argument that 26 U.S.C. 6662, which provides for penalties when a taxpayer misstates "the value of any property (or the adjusted basis of any property)" by more than a certain percentage, applies to a misstatement of basis only if a misstatement of value is "embedded" in that misstatement of basis.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-10) is reported at 515 F.3d 749. The opinion of the district court (Pet. App. 11-35) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on February 7, 2008. On April 4, 2008, Justice Stevens extended the time within which to file a petition for a writ of certiorari to and including June 6, 2008, and the petition was filed on that date. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. On August 13, 2000, the Internal Revenue Service (IRS) issued Notice 2000-44, 2000-2 C.B. 255, which alerted taxpayers that certain transactions designed to

create artificially high bases in partnership interests in order to manufacture artificial losses were ineffective for federal tax purposes. Pet. App. 20. The notice stated that losses claimed based on those transactions could be challenged under, *inter alia*, 26 U.S.C. 752, which addresses the proper treatment of liabilities by partners and partnerships. Pet. App. 22. The notice also stated that taxpayers who claim losses based on the transactions could be subject to accuracy-related penalties under 26 U.S.C. 6662, including penalties for misstating the value or adjusted basis of property. Pet. App. 22.[1]

More than three months later, Paul M. Daugerdas, a tax lawyer whose promotion of basis-inflating tax shelters of the sort described in Notice 2000-44 led to the demise of Jenkens & Gilchrist, P.C., implemented one of those shelters for the benefit of himself and a client. Pet. App. 2, 13-15. Daugerdas utilized three entities for the shelter (in addition to a wholly-owned entity through which he held his share of the other three entities): Cemco Investors, LLC (Cemco), Cemco Investment Partners (the Partnership), and Cemco Investors Trust (the Trust). *Id.* at 13.

On December 4, 2000, the Trust purported to pay Deutsche Bank (the Bank) a premium of $3.6 million for the right to receive $7.2 million from the Bank if the dollar-to-euro exchange rate was less than or equal to $.8652 per euro on December 19, 2000; simultaneously, the Bank purported to pay the Trust a premium of $3.564 million for the right to receive $7.128 million from

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[1] Unless otherwise indicated, all references in this brief to the relevant statutory provisions are to the 2000 edition of the United States Code. Although there have been some changes to the provisions since that time, they do not affect the legal analysis of the case.

the Trust if the dollar-to-euro exchange rate was less than or equal to $.8650 per euro on that date. Pet. App. 2-3, 14. The offsetting premium "payments" for the option contracts were effected by a transfer from the Trust to the Bank of $36,000 (the difference between $3.6 million and $3.564 million). *Id.* at 3. The Bank promised to refund $30,000 of that $36,000 if the option contracts offset each other on the exercise date. *Ibid.* On December 5, 2000, the Trust assigned its contractual right to the Partnership, which in turn assumed the Trust's corresponding contractual obligation. *Id.* at 14-15.

On December 18, 2000, the Partnership purchased just under 56,000 euros for $50,000. Pet. App. 3, 15. The next day, the option contracts offset each other, and the Bank refunded $30,000 to the Partnership. *Ibid.* The Partnership liquidated two days later, distributing the euros and some leftover cash to the Trust. *Ibid.*

On December 26, 2000, the Trust transferred the euros to Cemco. Pet. App. 15. Three days later, Cemco sold the euros for approximately $51,325. *Ibid.* Cemco reported a loss of approximately $3,563,212 from this sale on its 2000 tax return, even though the Partnership had purchased the euros for only $50,000 eleven days before Cemco sold them for $51,325. *Ibid.* The claimed loss is based on the theory that, in determining the Trust's basis in the Partnership (its outside basis), the payment side of the transactions must be taken into account, while the offsetting obligation side must be ignored because of its allegedly contingent nature. *Id.* at 15-16, 23. Thus, the Trust claimed an aggregate basis in the Partnership of approximately $3.6 million for an investment of only $36,000. That disconnect ultimately led to Cemco's claimed loss of approximately $3,563,212 on

the sale of the euros, even though the out-of-pocket costs of its principals were approximately $6000.[2]

The IRS disallowed the claimed loss on various grounds, including that, under Section 752 and its implementing regulations, the obligation side of the transactions had to be treated as a liability that reduced the Trust's outside basis in the Partnership. See Pet. App. 17; Pet. C.A. App. A62. The IRS also determined that Cemco's underpayment of tax was subject to penalties under Section 6662, including the 40% penalty for egregious misstatements of value or basis (gross valuation misstatements). *Id.* at A62-A63; see 26 U.S.C. 6662(h).

2. Petitioners sought review of the IRS's determinations in the United States District Court for the Northern District of Illinois. Pet. App. 12. The district court granted summary judgment in favor of the United States. *Id.* at 11-35.

The district court held that Cemco's claimed loss was precluded by 26 C.F.R. 1.752-6. Pet. App. 20-31. That regulation was promulgated, initially in temporary form, on June 24. 2003, to implement the IRS's position, expressed in Notice 2000-44, that losses generated by tax shelters like the one utilized by petitioners are inconsistent with Section 752. *Id.* at 5-6, 22. The district court explained that the regulation makes clear that, when, in connection with a partner's contribution of property to a partnership, the partnership assumes the partner's obligation to make a payment, whether fixed or contingent, that obligation must be reflected as a reduction in

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[2] The purchase and sale of the euros was a necessary part of the scheme because, under 26 U.S.C. 732(b), a partner's outside basis attaches to any property distributed to him in kind in liquidation of his interest. The euros served as "property" to which the Trust's inflated outside basis in the Partnership could attach.

the partner's outside basis. See *id.* at 22-23. The court further noted that the regulation by its terms applies to transactions, such as petitioners', which occurred between October 19, 1999, and June 23, 2003. See *ibid.* (citing 26 C.F.R. 1.752-6(d)).[3]

Petitioners acknowledged that the regulation disallowed losses of the type that Cemco claimed, Pet. App. 23, and they did not argue that the regulation could not be applied retroactively to the transactions at issue, see *id.* at 25 & n.6. Instead, petitioners argued that the IRS could not disallow Cemco's claimed loss because the IRS could adjust the basis of the euros only by issuing a notice of adjustment to the Partnership, and, absent such a notice, Cemco was required to use the basis assigned to the euros by the Partnership. See *id.* at 24-31. The district court rejected those arguments. See *ibid.*

The district court also rejected petitioners' challenge to the valuation misstatement penalties. Pet. App. 31-35. Section 6662 provides for penalties when an underpayment of tax is "attributable to," among other things, a "substantial valuation misstatement" or a "gross valuation misstatement[]." 26 U.S.C. 6662(b) and (h). As the district court explained, "a substantial valuation misstatement occurs when 'the value of any property (or the adjusted basis of any property) claimed on any return of tax . . . is 200 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).'" Pet. App. 32 (quoting 26 U.S.C. 6662(e)(1)(A)). The definition of "gross valuation misstatement," the court further explained, is the same, except that the penalty is increased to 40%

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[3] A much more detailed set of rules applies to transactions occurring on or after June 24, 2003. See 26 C.F.R. 1.752-7.

and the amount claimed on the tax return must be 400% or more of the correct value or adjusted basis. *Ibid.*

Petitioners argued that "a misstatement of 'adjusted basis' should be punishable under section 6662 only if a misstatement of value 'is embedded in [the] misstatement of adjusted basis.'" Pet. App. 33 (quoting Pet. Br. in Supp. of Mot. for Partial Summ. J. 15). According to petitioners, that interpretation of the statute was required because of the parentheses around the phrase "or the adjusted basis of any property" in Section 6662(e)(1)(A). See *ibid.* The district court rejected petitioner's interpretation as contrary to "the clear statutory language." *Ibid.* The court observed that, "[w]hile Cemco makes a valiant effort to overcome the language of section 6662, it has included nothing in its briefs to indicate that an interpretation such as it describes was intended." *Id.* at 33-34.

3. The court of appeals affirmed the district court's judgment. Pet. App. 1-10. After describing the transactions that petitioners had used to generate their claimed loss (*id.* at 1-4), and noting that "[t]he deal as a whole seems to lack economic substance" (*id.* at 4), the court considered and rejected petitioners' argument that Section 1.752-6 may not be applied retroactively to their transactions. *Id.* at 5-8. The court explained that "[t]he regulation could not be more explicit" that it "applies to assumptions of liabilities," like petitioners', "occurring after October 18, 1999, and before June 24, 2003." *Id.* at 6 (quoting 26 C.F.R. 1.752-6(d)(1)). The court acknowledged that, under 26 U.S.C. 7805(b)(1), IRS regulations "generally do not apply to transactions" that predate publication of the regulations. Pet. App. 6. The court noted, however, that, under the plain terms of Section 7805(b)(6), "the norm of prospective application 'may be

superseded by a legislative grant from Congress authorizing the Secretary to prescribe the effective date with respect to any regulation.'" *Id.* at 6-7 (quoting 26 U.S.C. 7805(b)(6)). The Court further explained that Congress had authorized the Secretary to prescribe an effective date for the regulation in this case in Section 309 of the Community Renewal Tax Relief Act of 2000 (2000 Act), Pub. L. No. 106-554, 114 Stat. 2763A-638. Pet. App. 7. That statute, the court explained, enacted basis-reduction rules for many transactions and authorized the IRS to adopt regulations prescribing similar rules for partnerships and to make those regulations retroactive to October 18, 1999. See *ibid.*

The court of appeals stated that one district court, in *Klamath Strategic Inv. Fund, LLC* v. *United States*, 440 F. Supp. 2d 608 (E.D. Tex. 2006), appeal pending, No. 07-40861 (5th Cir. filed Sept. 7, 2007), had concluded that the retroactivity of Section 1.752-6 cannot rest on the 2000 Act because the IRS had not availed itself of that authority in promulgating the regulation. Pet. App. 7. The court of appeals concluded, however, that the IRS had clearly relied on the authority provided by the 2000 Act because the IRS had chosen October 18, 1999, as the effective date for the regulation. *Ibid.*

The court therefore held that Section "1.752-6 applies to this deal and prevents Cemco's investors from claiming a loss." Pet. App. 7. The court observed that "Cemco is scarcely in a position to complain—not only because this tax shelter was constructed after the warning in Notice 2000-44, but also because all the regulation does is instantiate the pre-existing norm that transactions with no economic substance don't reduce people's taxes." *Id.* at 7-8.

The court of appeals also rejected petitioners' renewed arguments that the IRS could not disallow Cemco's claimed loss because the IRS could adjust the basis of the euros only by issuing a notice of adjustment to the Partnership, and, absent such a notice, Cemco was required to use the basis assigned to the euros by the Partnership. Pet. App. 8-10. Petitioners also renewed their argument that "a misstatement of adjusted basis is not within the scope of the penalty" provisions of Section 6662 "unless a misstatement of valuation is embedded in that misstatement of adjusted basis." Pet. C.A. Br. 38. The court of appeals rejected that argument without addressing it in the opinion.

ARGUMENT

Petitioners contend that this Court's review is warranted because, "[t]hrough its decision below, the Seventh Circuit entered both a three-way circuit split on the meaning of the economic substance doctrine and a two-way split on the meaning of the valuation-misstatement penalty statute." Pet. 11. Contrary to that contention, the court of appeals did not take a position on either of the circuit conflicts identified by petitioners. Instead, the decision below rested on other grounds, which the court of appeals decided correctly and which petitioners have not challenged in their petition for a writ of certiorari. Accordingly, this Court's review is not warranted.

1. a. Petitioners err in contending that "the Seventh Circuit subtly adopted a view of the [economic substance] doctrine that conflicts with the holdings of at least five other circuits." Pet. 12. On the contrary, neither the district court nor the court of appeals rested its judgment on the economic substance doctrine, the application of which entails a fact-laden inquiry. Instead, the

district court held that Cemco's claimed loss was precluded by Section 1.752-6, a mechanical basis-reduction rule that obviates the need for any factual inquiry into the subject transactions' economic substance. Pet. App. 20-25. The court of appeals agreed, rejecting petitioners' argument that the regulation could not validly be applied retroactively to petitioners' transactions. *Id.* at 5-7.

The court of appeals did not rest its decision on the economic substance doctrine, much less silently take sides in a disagreement about the contours of that doctrine. Petitioners' contention that it did (Pet. 11-12, 17-18) is based entirely on two isolated sentences of *dicta* in the court's opinion. Petitioners rely on the court's passing statement that "[t]he deal as a whole seems to lack economic substance." Pet. 11-12 (emphasis omitted) (quoting Pet. App. 4). But the court made that statement, which does not even take a conclusive position on whether the transactions lacked economic substance, in describing the facts of the case and before addressing the legal issues. See Pet. App. 4. Petitioners also rely on the court's statement that Section 1.752-6 merely served to "instantiate the pre-existing norm that transactions with no economic substance don't reduce people's taxes." Pet. 12 (quoting Pet. App. 7-8). But the court made that statement after it had already held that Section "1.752-6 applies to this deal and prevents Cemco's investors from claiming a loss." Pet. App. 7. Because the court of appeals' decision did not rest on the economic substance doctrine, this case does not present the Court with an opportunity to resolve any disagreement among the courts of appeals in their approach to that doctrine.

b. The actual holding of the court of appeals—that Section 1.752-6 validly applies retroactively to petitioners' transactions—is correct and does not warrant review. As the court of appeals explained, Section 1.752-6 expressly states that it "applies to assumptions of liabilities," like petitioners', "occurring after October 18, 1999, and before June 24, 2003." Pet. App. 6 (quoting 26 C.F.R. 1.752-6(d)(1)). Although IRS regulations "generally do not apply to transactions" that predate publication of the regulations, see 26 U.S.C. 7805(b)(1), that limitation on retroactive application "may be superseded by a legislative grant from Congress authorizing the Secretary [of the Treasury] to prescribe the effective date with respect to any regulation," 26 U.S.C. 7805(b)(6). As the court of appeals concluded, the Secretary's decision to prescribe an effective date for Section 1.752-6 was authorized by Section 309 of the 2000 Act, 114 Stat. 2763A-638. Pet. App. 7. That statute prescribed basis-reduction rules for many transactions and authorized the IRS both to adopt regulations prescribing similar rules for partnerships and to make those regulations retroactive to October 18, 1999. See *ibid.*

Petitioners incorrectly criticize the court of appeals for failing to conduct what petitioners term a "conventional retroactivity analysis" (Pet. 12) of the kind conducted in *Snap-Drape, Inc.* v. *Commissioner*, 98 F.3d 194 (5th Cir. 1996), cert. denied, 522 U.S. 821 (1997). See Pet. 12, 21-22. The analysis in *Snap-Drape* and similar cases, dealing with retroactive regulations issued pursuant to a prior version of 26 U.S.C. 7805(b) (1994), has no application to retroactive regulations issued pursuant to Section 7805(b)(6), which was enacted in 1996.

In *Snap-Drape*, the Fifth Circuit applied a four-factor test—based largely on fairness concerns, includ-

ing whether the taxpayer had justifiably relied on prior law—in reviewing the Commissioner's promulgation of a retroactive regulation pursuant to the pre-1996 version of Section 7805(b). See 98 F.3d at 202. Under that version of Section 7805(b), the Commissioner generally was authorized to issue retroactive regulations, subject to judicial review for abuse of discretion. See, *e.g.*, *Gehl Co.* v. *Commissioner*, 795 F.2d 1324, 1332 (7th Cir. 1986). In 1996, however, Congress entirely revised the Commissioner's authority to issue retroactive regulations. See Taxpayer Bill of Rights 2, Pub. L. No. 104-168, § 1101(a), 110 Stat. 1468. As amended, Section 7805(b) now generally prohibits the Commissioner from issuing retroactive regulations. See 26 U.S.C. 7805(b)(1). There are, however, specific exceptions to the general prohibition against retroactivity, see 26 U.S.C. 7805(b), and, as the court of appeals correctly held (Pet. App. 6-7), the Commissioner relied on one of those exceptions here—a legislative grant of authority to prescribe a regulation's effective date, 26 U.S.C. 7805(b)(6).

When the Commissioner promulgates a retroactive regulation pursuant to a specific legislative grant of authority, that action is not subject to judicial review for abuse of discretion because it is expressly authorized by Section 7805(b)(6). Instead, a reviewing court is limited to determining whether, as a matter of law, the regulation falls within the scope of the legislative grant of authority. That is precisely the determination that the Seventh Circuit made in the decision below, and petitioners have not challenged that determination in this Court. Accordingly, the court of appeals' decision that Cemco is not entitled to its claimed loss does not warrant this Court's review.

2. Petitioners' request for review of the court of appeals' ruling affirming the penalties under Section 6662 is similarly misconceived. Petitioners incorrectly contend (Pet. 22-31) that this case presents this Court with the opportunity to resolve a disagreement among the courts of appeals over the scope of Section 6662. Contrary to that contention, the decision below does not implicate the disagreement identified by petitioners. And petitioners have not challenged the actual holding of the court of appeals on the penalty issue.

a. The disagreement among the courts of appeals identified by petitioners actually concerns the scope of 26 U.S.C. 6659 (1988), the now-repealed predecessor to Section 6662. Similar to Section 6662, that section provided for penalties for certain underpayments of tax when those tax underpayments were "attributable to" a valuation overstatement. 26 U.S.C. 6659(a) (1988) (repealed 1989). The disagreement concerns whether an underpayment of tax is "attributable to" an overstatement of value or basis in situations where deductions or credits premised on the overstated value or basis are disallowed in their entirety based on some other rule or doctrine. Compare, *e.g.*, *Todd* v. *Commissioner*, 862 F.2d 540 (5th Cir. 1988) (valuation misstatement penalty not applicable to underpayment resulting from disallowance of depreciation deductions and investment tax credits based on taxpayers' failure to place the subject assets in service during the year in issue), with *Massengill* v. *Commissioner*, 876 F.2d 616 (8th Cir. 1989) (valuation misstatement penalty applicable to underpayments resulting from disallowance of depreciation deductions and investment tax credits based on taxpayers' failure to acquire tax ownership of the subject assets under economic substance doctrine).

Even assuming that the courts that disagree over the scope of Section 6659 would have the same disagreement about the scope of Section 6662 (which also contains the phrase "attributable to"), that disagreement is not implicated by this case. Petitioners assert that, "[b]y rejecting Cemco's challenge to the valuation misstatement penalty, the Seventh Circuit implicitly sided with those courts that take a broad view" of when an underpayment is "attributable to" a misstatement of value or basis. Pet. 25. That assertion is incorrect. Petitioners never argued in the court of appeals that Cemco's understatement of tax was not "attributable to" a misstatement of value or basis because Cemco's basis in the euros was eliminated based on Section 1.752-6. Nor did petitioners' briefs in the court of appeals allude to any disagreement among the courts of appeals on the scope of the penalty provisions, much less urge the court of appeals to "t[ake] sides" in that disagreement. Pet. 22. Petitioner's sole argument on the penalty issue was that "a misstatement of adjusted basis is not within the scope of the penalty unless a misstatement of valuation is embedded in that misstatement of adjusted basis." Pet. C.A. Br. 38; see *id.* at 33-41; see Pet. C.A. Reply Br. 18-20. By rejecting that argument, the court of appeals did not express any view on the disagreement among the courts of appeals that petitioner now asks this Court to resolve. Accordingly, this case does not present an opportunity for the Court to resolve that disagreement.

Petitioners insist that the penalty issue raised in their petition for a writ of certiorari is properly presented because "Cemco argued, both before the district and circuit courts, that the IRS could not apply § 6662 against it," and "the traditional 'pressed or passed upon' rule for granting certiorari requires only that a claim be

'pressed' *or* 'passed upon,' not both." Pet. 25 (quoting *United States* v. *Williams*, 504 U.S. 36, 41 (1992)). But *Williams* articulates the "pressed or passed upon" rule in terms of issues or questions presented, not "claim[s]." Although Cemco certainly pressed below its generalized claim that "the IRS could not apply § 6662 against it," *ibid.*, it did not, as discussed above, press the issue that is the subject of the "longstanding circuit split" (*ibid.*) that petitioners now ask this Court to resolve (*i.e.*, whether an underpayment is "attributable to" an overstatement of value or basis when deductions or credits premised on the overstated value or basis are disallowed in their entirety for some other reason). That issue was neither pressed nor passed upon by the court of appeals, and it is not properly before this Court.

b. The penalty issue that the court of appeals did resolve also does not warrant this Court's review. By affirming the district court's judgment upholding the valuation misstatement penalty, the court of appeals implicitly rejected petitioners' argument that basis overstatements are subject to Section 6662 penalties only if they involve an "embedded" valuation misstatement. The court of appeals was correct to reject that argument, which, as the district court explained (Pet. App. 32-34), is contrary to Section 6662's plain text. See 26 U.S.C. 6662(e)(1)(A) (treating misstatements of "the value of any property" and misstatements of "the adjusted basis of any property" interchangeably). Indeed, the court of appeals apparently did not even consider the argument worth addressing in its opinion, and petitioners have not renewed the argument in their petition for a writ of certiorari. Accordingly, there is no reason for this Court to consider it.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

GREGORY G. GARRE
Acting Solicitor General
GILBERT S. ROTHENBERG
Acting Assistant Attorney General
RICHARD FARBER
ARTHUR T. CATTERALI
Attorneys

AUGUST 2008

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(4)

No. 07-1526

FILED
AUG 19 2008
OFFICE OF THE CLERK
SUPREME COURT, U.S.

In the Supreme Court of the United States

CEMCO INVESTORS, LLC, AND
FOREST CHARTERED HOLDINGS LTD.,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

REPLY TO BRIEF IN OPPOSITION

THOMAS D. SYKES
MCDERMOTT WILL & EMERY LLP
227 W. Monroe St., 56th Floor
Chicago, IL 60606
(312) 372-2000

M. MILLER BAKER
Counsel of Record
PAUL M. THOMPSON
JEFFREY W. MIKONI
TIMOTHY S. SCHUMAN
MCDERMOTT WILL & EMERY LLP
600 Thirteenth St., N.W.
Washington, D.C. 20005
(202) 756-8000

Attorneys for Petitioners
(Additional counsel listed on inside cover)

August 19, 2008

Additional Counsel for Petitioners:

RORY K. LITTLE
HASTINGS COLLEGE OF
LAW (U.C.)
200 McAllister St.
San Francisco, CA 94102
(415) 565-4669

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REPLY TO BRIEF IN OPPOSITION

Rather than address Cemco's questions presented, the government dodges them by arguing that the decision below was decided on other grounds. The government's sidesteps, however, are unavailing.

Even though the Seventh Circuit did not discuss the first question presented in any detail, and the second at all, both questions were fairly preserved below, and both are implicated by the Seventh Circuit's decision. As such, the petition presents two critical questions to this Court—questions that the government has made no effort to persuade do not warrant this Court's attention on their own merits.

1. The Seventh Circuit determined that Treas. Reg. § 1.752–6 was permissibly retroactive as to the transaction at issue for two reasons.[1] First, Code Section 7805(b)(6) creates an exception to the norm of prospective application if there is a "legislative grant from Congress authorizing the Secretary to prescribe the effective date with respect to any regulation." 26 U.S.C. § 7805(b)(6). According to the Seventh Circuit, Congress did that in Section 309(d)(2) of the Community Renewal Tax Relief Act

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[1] Though the government also suggests that Cemco somehow conceded the applicability and retroactivity of Treas. Reg. § 1.752–6, both points were contested in the courts below. Pet. C.A. Br. 13–16; Pet. C.A. Reply 16 n. 15. The district court's contrary statement, upon which the government relies, is incorrect. Br. in Opp. 5 (citing App. 23, 25 & n.6).

of 2000, Pub. L. 106-554, 114 Stat. 2763A-587 (2000). *See* App. 6–7.[2]

Second, the Seventh Circuit held retroactive application was permissible because Cemco's transaction lacked economic substance. According to the court of appeals, the IRS always "has a statutory power to disregard transactions that lack economic substance," and "has considerable latitude in issuing regulations that specify sorts of transactions that may be looked through." App. 5. The court of appeals then explained that by issuing regulations on particular transactions that lack economic substance, the IRS "avoid[s] the need to litigate, one tax shelter at a time, whether any real economic transaction is inside the box." App. 5. With these fundamental assumptions in place, the court of appeals cited the Federal Circuit's decision in *Coltec*—a case interpreting the economic substance doctrine—in order to justify retroactive application of the regulation "because all the regulation does is instantiate the pre-existing norm that transactions with no economic substance don't reduce people's taxes." App. 7–8 (citing *Coltec Indus., Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006)). In other words, because the transaction lacked economic substance, it was unnecessary to consider Cecmo's

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[2] Section 309(d)(2) of the Act provides that any regulations adopted under subsection (c) "shall apply to assumptions of liability after October 18, 1999, or such later date as may be prescribed in such rules[,]" thus vesting in the Secretary discretionary authority to promulgate retroactive regulations implementing Section 309 of the Act. *See* Pub. L. 106-554, 114 Stat. 2763A-587 (2000).

"complain[t]" that the regulation was *impermissibly* retroactive. App. 7.

The government argues that the second half of the Seventh's Circuit's retroactivity analysis—that it was unnecessary to even consider whether the regulation was permissibly retroactive because the transaction lacked economic substance—was mere dicta because Section 7805(b)(6) expressly authorized retroactivity. *See* Br. in Opp. 11. The government asserts, on its own *ipse dixit*, that the regulation is not subject to judicial review for abuse of discretion. *Id.* Instead, according to the government, "a reviewing court is limited to determining whether, as a matter of law, the regulation falls within the scope of the legislative grant of authority." *Id.*

In so arguing, the government seems to assume that the 1996 amendment to 26 U.S.C. § 7805(b) rendered obsolete decades of case law applying an abuse-of-discretion standard to the Commissioner's decision to make regulations retroactive—including retroactive regulations authorized by express legislative grants. *See, e.g., Anderson, Clayton & Co. v. United States*, 562 F.2d 972, 984–985 (5th Cir. 1977) (same abuse-of-discretion retroactivity analysis applies whether regulation is interpretative or legislative, *i.e.*, expressly authorized by statute); *Snap-Drape, Inc. v. Comm'r*, 98 F.3d 194, 202 (5th Cir. 1996) (applying four *Anderson* abuse-of-discretion factors to retroactive legislative regulation). This position is particularly striking given that, when revising Section 7805(b) in 1996, Congress reversed the statutory presumption of

retroactivity and replaced it with a statutory presumption against retroactivity—Congress *restricted* the Commissioner's discretion to make regulations retroactive to specifically enumerated circumstances. *See* H.R. Rep. No. 104-506, at 44 (1996) ("The Committee believes that it is generally inappropriate for Treasury to issue retroactive regulations.").

Not surprisingly, then, leading tax commentators agree that the abuse of discretion standard continues to apply to retroactive regulations issued pursuant to the express grants of authority contained in amended Section 7805. *See* Michael I. Saltzman, IRS PRACTICE AND PROCEDURE ¶ 3.02[4] (rev. 2d ed. 2007) ("These decisions and other case law on retroactive regulations still have relevance today."); FEDERAL TAX COORDINATOR ¶ T-10103.1 (2d ed. 2008) ("[B]efore July 30, '96, the current statutory rules regarding retroactivity of tax regs didn't apply, IRS had broad discretion to make regs retroactive and IRS's promulgation of retroactive regs was reviewable for abuse of discretion. The cases, etc. discussed below were decided under the pre-July 30, '96 law, and thus their applicability under current law is somewhat unclear. However, it would seem reasonable that the courts will continue to consider challenges based on the argument that the retroactive application of a particular reg represents an abuse of IRS's discretion under the statute.").

Indeed, in the court of appeals, the government *conceded* that retroactive regulations issued pursuant to the Secretary's specific authority under

Section 7805(b)(3) to prevent abuse were subject to judicial review for abuse of discretion:

> Prior to 1996, there was no statutory provision specifically authorizing the Secretary to promulgate retroactive regulations in order to prevent abuse. Instead, the Secretary was generally authorized to issue retroactive regulations, subject to judicial review for abuse of discretion. *See* 26 U.S.C. § 7805(b) (1994); *Gehl Co. v. Comm'r*, 795 F.2d 1324, 1332 (7th Cir. 1986).
>
> *Presumably, the Secretary's specific authority under § 7805(b)(3) to issue retroactive regulations in order to prevent abuse—an exception to the general prohibition against retroactive regulations effected by the 1996 amendment of § 7805(b)—is subject to judicial review for abuse of discretion as well.*

Resp. C.A. Br. 42-43 (emphasis added). Section 7805(b)(3), like Section 7805(b)(6), is a specific grant of legislative authority to issue retroactive regulations. If regulations issued pursuant to Section 7805(b)(3) are subject to judicial review for abuse of discretion as the government conceded below, then in principle so must regulations issued pursuant to Section 7805(b)(6).

The closest the Seventh Circuit came to engaging in this mandatory abuse-of-discretion analysis is its conclusory finding that Cemco "is

scarcely in a position to complain" about retroactive application of Treas. Reg. § 1.752–6, because the regulation merely "instantiate[d] the pre-existing norm that transactions with no economic substance don't reduce people's taxes." App. 7–8. As already stated, in reaching that holding, the Seventh Circuit relied upon *Coltec*—a decision that took a clear position in a deeply-entrenched circuit split regarding the proper understanding of the economic substance doctrine. Pet. 11–18. As the Seventh Circuit's retroactivity analysis is predicated upon its decision to adopt *Coltec*'s understanding of the economic substance doctrine, Cemco's petition properly challenges the court of appeals' economic substance analysis.

In other words, the court of appeals justified retroactive application of Treas. Reg. § 1.752–6 through its conclusion that the transaction violated the economic substance doctrine. If that conclusion was incorrect, as Cemco argues, then the Seventh Circuit's retroactivity analysis must fall.

2. The government's efforts to minimize the importance of the courts of appeals' disagreement regarding the proper scope of 26 U.S.C § 6662's valuation-misstatement penalty are similarly misdirected. The division among the circuits remains relevant, and Cemco's arguments before this Court are fairly embraced within its claims pressed below.

a. In order to avoid the import of the long-standing circuit split regarding the proper application of the valuation-misstatement penalty in

cases such as this, the government first seeks to frame the conflict as a relic of a bygone era, tied to a repealed prior version of the penalty statute. Br. in Opp. 12–13 ("The disagreement among the courts of appeals identified by petitioners actually concerns the scope of 26 U.S.C. [§] 6659 (1988), the now-repealed predecessor to Section 6662."). In doing so, the government unfairly downplays the textual similarity between modern Section 6662 and its predecessor.

Though the Omnibus Reconciliation Act of 1989 consolidated former Section 6659, along with other accuracy-related penalties, into modern Section 6662, the reorganization and recodification "carr[ied] over the same essential language." *Santa Monica Pictures, LLC v. Comm'r*, 89 T.C.M. 1157, n.191 (2005). Courts interpreting Section 6662's valuation-misstatement penalty have thus continued to apply the divided precedents that arose under prior versions, *see id.*, and no court has suggested that the division between the courts of appeals has been obviated by the statute's minor intervening amendments. Indeed, the government's suggestion that pre-amendment caselaw is no longer relevant to interpretation of modern Section 6662 stands in stark contrast to its arguments below, wherein it *relied* upon cases interpreting former Section 6659. *See* Resp. C.A. Br. 72 (citing *Gilman v. Comm'r*, 933 F.2d 143 (2d Cir. 1991)). There is no reason to believe that the circuit split regarding proper application of the valuation-misstatement penalty statute does not remain vital under 26 U.S.C. § 6662.

b. The government next insists that because Cemco did not adequately "press" its question presented below, Cemco's argument that the Seventh Circuit's decision implicitly deepens the split regarding proper application of Section 6662 "is not properly before this Court." Br. in Opp. 14. Yet the government concedes that "Cemco certainly pressed below its generalized claim that 'the IRS could not apply § 6662 against it,'" Br. in Opp. 14 (quoting Pet. 25), a statement well-supported by the record in this case. The district court understood the nature of Cemco's argument, stating that "Cemco's second amended petition challenges the valuation misstatement penalties on the basis that the underpayment of tax alleged in the FPAA is not *attributable to a misstatement of value*." App. 32 (emphasis added); *see also* App. 32–33 ("Because the underpayment of tax does not result from an incorrect valuation, Cemco contends, a valuation misstatement penalty cannot be imposed as a matter of law."). Cemco made the same assault on the application of the valuation-misstatement provision in the court of appeals: "[D]issallowance of the claimed loss (as determined by the IRS's FPAA) is *not attributable to an incorrect valuation*[.]" Pet. C.A. Br. 33 (emphasis added). Although Cemco did not cite below all the cases identified in the split presented to this Court, it unquestionably challenged the application of the valuation-misstatement provision. App. 32–33; Pet. C.A. Br. 33–34, 37.

Under this Court's jurisprudence, Cemco's arguments below are more than sufficient to support its petition. *See Lebron v. Nat'l R.R. Passenger*

Corp., 513 U.S. 374, 379 (1995) ("Our traditional rule is that 'once a federal claim is properly presented, a party can make any argument in support of that claim; *parties are not limited to the precise arguments they made below*.'" (emphasis added)); *see also Yee v. City of Escondido*, 503 U.S. 519, 534–535 (1992). In *Lebron*, the Court held that a party was free to argue that Amtrak was a part of the federal government even though it had "expressly disavowed" the argument below; the party's general "claim" was that Amtrak had failed to respect his First Amendment rights, and he therefore was free to raise a new argument in support of that claim before the Court. 513 U.S. at 378–379. Similarly, Cemco's claim—presented to both the district court and the court of appeals—is that the IRS cannot apply § 6662 to its transactions. The fact that Cemco's petition refines this argument is no barrier to this Court's review.

3. With these procedural concerns addressed, the government's Brief in Opposition makes no effort to discount the existence and importance of the questions presented by Cemco's petition, Pet. 10–28, nor does it undermine the fact that this Court's review is necessary to bring clarity and stability to two long-unstable areas of federal tax law, Pet. 29–31. Cemco will therefore not belabor that which the government has not contested: that the lower courts remain divided over two complex issues which warrant this Court's immediate attention.

CONCLUSION

For the reasons provided above and in the petition for a writ of certiorari, the Court should grant the petition.

Respectfully submitted,

THOMAS D. SYKES
MCDERMOTT WILL & EMERY LLP
227 W. Monroe St., 56th Floor
Chicago, IL 60606
(312) 372-2000

RORY K. LITTLE
HASTINGS COLLEGE OF LAW (U.C.)
200 McAllister St.
San Francisco, CA 94102
(415) 565-4669

M. MILLER BAKER
Counsel of Record
PAUL M. THOMPSON
JEFFREY W. MIKONI
TIMOTHY S. SCHUMAN
MCDERMOTT WILL & EMERY LLP
600 Thirteenth St., N.W.
Washington, D.C. 20005
(202) 756-8000

Attorneys for Petitioners

August 19, 2008

FILED
JUL 9 - 2008
OFFICE OF THE CLERK
SUPREME COURT, U.S.

No. 07-1526

IN THE

Supreme Court of the United States

CEMCO INVESTORS, LLC AND
FOREST CHARTERED HOLDINGS, LTD.,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

BRIEF *AMICUS CURIAE* OF STOBIE CREEK INVESTMENTS, LLC IN SUPPORT OF PETITIONER

NEIL LLOYD
SCHIFF HARDIN LLP
6600 Sears Tower
Chicago, IL 60606
(312) 258-5628

ROBERT E. KOLEK
Counsel of Record
SCHIFF HARDIN LLP
6600 Sears Tower
Chicago, IL 60606
(312) 258-5755

Counsel for Amicus Curiae
Stobie Creek Investments, LLC

216818

COUNSEL PRESS
(800) 274-3321 • (800) 359-6859

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INTEREST OF AMICUS CURIAE[1]

Stobie Creek is filing this amicus brief because it has a case pending in the U.S. Court of Federal Claims, *Stobie Creek Investments LLC v. United States*, No. 05-748, which concerns similar questions of economic substance and penalties. The Claims Court in *Stobie Creek* recognizing the importance of the *Cemco* decision, requested post-trial briefing on the decision in *Cemco*, albeit concerning Treas. Reg. § 1.752-6. Evidence has closed and post-trial briefing has been completed in the *Stobie Creek* matter and the parties are awaiting a decision.

Stobie Creek was formed in 2000 to hold a family's combined investments before and upon the sale of half of their family business. In March 2000, the Stobie Creek members, through their respective LLCs and a Family Trust, transferred foreign currency options to Stobie Creek. They did so expecting a profit on their investment. In reporting income for the year 2000, Stobie Creek and its members determined their income consistent with the then-applicable Internal Revenue Code and Treasury regulations. Upon audit, the IRS increased Stobie Creek's income, and consequently its

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[1] Pursuant to Supreme Court Rule 37.6, *amicus* states that the brief was authored in its entirety by *amicus curiae* and its counsel. No monetary contribution toward the preparation or submission of this brief was made by any person other than *amicus curiae*, its members and its counsel. By letters filed with the Clerk of the Court, petitioner and respondent have consented to the filing of this brief and have been given at least 10 days notice of such filing.

members', relying in substantial part on the economic substance doctrine and the retroactive application of Treas. Reg. § 1.752-6.

Stobie Creek is vitally affected by and interested in the determination of the proper tests for economic substance and application of the valuation-misstatement penalty under 26 U.S.C. § 6662. Countless other taxpayers are similarly situated.

This Court's review now is important because of the IRS's increasing aggressiveness in asserting that transactions lack economic substance whenever a taxpayer attempts to structure a transaction to secure favorable tax consequences. *See* Eileen J. O'Conner, *Enforcement Is Progressing, Justice Department Attorney Testifies At Senate Finance Hearing*, 114 Tax Notes 42 (June 14, 2006). Taxpayers, like Stobie Creek, need to be able to predict *ex ante*, and with reasonable certainty, the tax consequences of transactions they contemplate.

As one among many partnerships whose partners contributed contingent liabilities, Stobie Creek respectfully files its amicus brief, urging that this Court clarify the scope and validity of the economic-substance doctrine and the application of 26 U.S.C. § 6662, resolving current conflict among the federal appellate courts.

PRELIMINARY STATEMENT

Petitioners seek review of *Cemco Investors, LLC and Forest Chartered Holdings Ltd. v. United States*, 515 F.3d 749 (7th Cir. 2008), on the ground that the federal appellate courts disagree about the proper economic substance test and on application of 26 U.S.C. § 6662, the valuation-misstatement penalty. Stobie Creek, as amicus curiae, urges that the Court grant review to clarify the proper test for determining whether a transaction has economic substance. The appellate courts are profoundly divided on the proper economic substance and for determining the application of the valuation misstatement penalty standard — indeed, two circuits apply a "conjunctive" test, three apply a "disjunctive" test, and other courts apply a "unitary" test. Additionally, the appellate courts are divided on the proper application of the valuation misstatement penalty.

REASONS FOR GRANTING REVIEW

I. REVIEW IS WARRANTED TO RESOLVE THE THREE-WAY CONFLICT.

In *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978), the Court held that the Government must honor "a genuine multi-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached." Since that decision, the courts of appeals have developed three divergent and non-harmonious standards under the

economic-substance doctrine. Specifically, they have divided over whether this Court has mandated a "conjunctive," "disjunctive," or "unitary" test. Indeed, the IRS's chief counsel has acknowledged the three-way split, noting that it invites this Court's intervention. *Korb Acknowledges U.S. Supreme Court May Need to Clarify Economic Substance Doctrine*, Daily Tax Rep. (BNA) (October 27, 2006), at pp. 2-3.

A. The Conjunctive Test

The Fourth and D.C. Circuits have adopted a two-prong "conjunctive" test. The Fourth Circuit has held: "To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, *and* that the transaction has no economic substance because no reasonable possibility of profit exists." *Rice's Toyota World, Inc. v. Comm.*, 752 F.2d 89, 91 (4th Cir. 1985) (emphasis added). In light of *Frank Lyon*, 435 U.S. 561, the Fourth Circuit concluded that "a transaction cannot be treated as a sham *unless* the transaction is shaped *solely* by tax avoidance considerations." *Rice's Toyota World*, 752 F.2d at 92 (emphases added); *Black & Decker*, 436 F.3d at 441.

The D.C. Circuit has adopted the same rule, noting that "[t]he Supreme Court's approach in [*Frank Lyon* and *United States v. Consumer Life Ins. Co.*, 430 U.S. 725 (1977)] demonstrates the separability of the 'business purpose' and the economic gain tests." *Horn v. Comm.*, 968 F.2d 1229, 1238 (D.C. Cir. 1992). "[A] transaction undertaken for a nontax business purpose will not be considered an economic sham even if there was no

objectively reasonable possibility that the transaction would produce profits." *Id.* at 1237 (emphasis omitted); *Id.* at 1237-38

> "'The test inquires into the existence of a business purpose for the transaction and evaluates the economic substance of the transaction. The latter evaluation is to be guided by a more precise test of whether there is a reasonable possibility of a profit. Only if neither test were satisfied would the transaction be considered a sham transaction.'"

(quoting Karen N. Moore, *The Sham Transaction Doctrine: An Outmoded and Unnecessary Approach to Combating Tax Avoidance*, 41 Fla. L. Rev. 659, 670 (1989)).

The Seventh Circuit appeared to have adopted the conjunctive test in *N. Indiana Public Serv. Co. v. Comm.*, 115 F.3d 506 (7th Cir. 1997) ("*Nipsco*"). There, the taxpayer formed a Netherland Antilles subsidiary corporation to obtain access to lower cost financing from foreign investors. By using a Netherland Antilles subsidiary to borrow in the European Market, the taxpayer obtained tax advantages through direct borrowing in that Market. The Commissioner, however, challenged the interest transactions between taxpayer and its subsidiary based on the taxpayer's tax-avoidance motive in creating this subsidiary. Specifically, the Commissioner argued that transactions lacking economic substance between related legitimate corporations could be disregarded. The Seventh Circuit

disagreed: "[I]t is unnecessary, and we think inappropriate for us to sever a corporation from its transactions in analyzing a case, such as this one, where the corporation was formed with the intent of structuring its economic transactions to take advantage of laws that afford tax savings." *Nipsco*, 115 F.3d at 512. Instead, the court endorsed "the principle that a corporation *and the form of its transactions* are recognizable for tax purposes, despite any tax-avoidance motive, so long as the corporation engages in bona fide economically-based business transactions." *Id.*

Here, however, the Seventh Circuit disregarded *Nipsco*, concluding instead that the transaction at issue "seem[ed] to lack economic substance." *Cemco*, Pet.App.4. And, departing from the conjunctive test, the court relied on *Coltec Indus., Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), finding that Treas. Reg. § 1-752-6 "instantiate[d] the pre-existing norm that transactions with no economic substance don't reduce people's taxes." *Cemco*, Pet.App. 7-8. This unannounced renunciation of the "conjunctive" test adds confusion to the issue of the proper analysis to be employed and is a further reason for granting review.

B. The Disjunctive Test

A second group of circuits (the Sixth, Eleventh, and Federal Circuits) have adopted a "disjunctive" test for economic substance. Under this test, the absence of *either* objective economic substance or subjective business purpose is fatal to the transaction. For example, the Eleventh Circuit, in *Winn-Dixie Stores, Inc. v. Comm.*, 254 F.3d 1313, 1316 (11th Cir. 2001), stated that

the "sham-transaction doctrine . . . provides that a transaction is not entitled to tax respect if it lacks economic effects or substance other than the generation of tax benefits, *or* if the transaction serves no business purpose." (Emphasis added). Additionally, "[o]nce a court determines a transaction [has no economic effects], no further inquiry into intent is necessary." *Kirchman v. Comm.*, 862 F.2d 1486, 1492 (11th Cir. 1989). Alternatively, "[e]ven if the transaction has economic effects, it must be disregarded if it has no business purpose and its motive is tax avoidance." *United Parcel Serv. of Am., Inc. v. Comm.*, 254 F.3d 1014, 1018 (11th Cir. 2001) ("*UPS*").

Similarly, the Sixth Circuit has held:

> 'The proper standard in determining if a transaction is a sham is whether the transaction has any practicable economic effects other than the creation of income tax losses.' If the transaction has economic substance, 'the question becomes whether the taxpayer was motivated by profit to participate in the transaction.' 'If, however, the court determines that the transaction is a sham, the entire transaction is disallowed for federal tax purposes, and the [subjective] inquiry is never made.'

Dow Chem. Co. v. United States, 435 F.3d 594, 599 (6th Cir. 2006) (internal citations omitted, alteration in original, emphasis added). The Federal Circuit follows the same disjunctive test. *Coltec Indus. Inc. v. United States*, 454 F.3d 1340, 1355 (Fed. Cir. 2006) ("[A] lack of

economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance."). Under this rule, an objective determination of lack of economic benefits alone is enough to disallow a transaction for tax purposes.

None of these courts' expressions of the disjunctive test is consistent with *Frank Lyon*, 435 U.S. 561. Indeed, to the extent that each formulation negates having to make a "subjective inquiry," it ignores *Frank Lyon*.

C. The Unitary Test

The Third, Ninth, and Tenth Circuits apply yet another test: the "unitary" test. In *ACM Partnership v. Comm.*, 157 F.3d 231 (3d Cir. 1998), the Third Circuit held: "[t]he inquiry into whether the taxpayer's transactions had sufficient economic substance to be respected for tax purposes turns on both the 'objective economic substance of the transactions' and the 'subjective business motivation' behind them." *Id.* at 247 (quoting *Casebeer v. Comm.*, 909 F.2d 1360, 1363 (9th Cir. 1990)); *accord James v. Comm.*, 899 F.2d 905, 908-909 (10th Cir. 1990) (viewing "business purpose and economic substance" as "factors to consider" in its economic substance analysis). These courts expressly reject the "conjunctive" test. *Casebeer*, 909 F.2d at 1363 (holding that the Fourth Circuit analysis "has no merit" because "the Court's holding in *Frank Lyon was not intended to outline a rigid two-step analysis*") (emphasis added); *James*, 899 F.2d at 908-909 (finding the Ninth Circuit to have a "better approach" than the

Fourth Circuit). The Third Circuit offered the following explanation for diverging from the "conjunctive" test:

> [the] distinct aspects of the economic sham inquiry do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.

ACM, 157 F.3d at 247 (quoting *Casebeer*, 909 F.2d at 1363).

The "unitary" test departs from the "disjunctive" test in that a finding of lack of objective economic substance does not end the inquiry. As support, the courts have reasoned that: "From the time of *Gregory's* [*v. Helvering*, 293 U.S. 465 (1935)] analysis of the 'rational business purpose,' courts have evaluated taxpayers' purposes when determining whether a transaction has economic substance." *In re CM Holdings, Inc.*, 301 F.3d 96, 106 (3d Cir. 2002).

CM Holdings, in particular, shows why this Court's intervention is imperative to ensure the federal tax laws are uniformly administered. Both among the various appellate courts — and within the Seventh Circuit itself — there is a profound lack of coherence. Taxpayers need to be able to predict, with reasonable accuracy, the tax consequences of transactions they contemplate.

II. APPLICABILITY OF THE VALUATION – MISSTATEMENT PENALTY

The Petition also notes a split among the circuits regarding the applicability of the valuation – misstatement penalty. The Fifth and Ninth Circuits follow the rule that when the underpayment of tax results from a disallowance of a deduction or credit, it is not considered attributable to a valuation overstatement, and the 26 U.S.C. § 6662 penalty accordingly does not apply. The Third, Fourth, Sixth and Eighth Circuits, and now the Seventh Circuit, however, reach the opposite conclusion.

In the case of partnerships not subject to the unified audit and judicial procedures,[2] which have partners residing in several jurisdictions, the split between the circuits can lead to inconsistent rulings on the same facts. Partners in a small partnership will be subject to individual audits with final determinations governed by the law of the Circuit to which an appeal would be made. See *Golsen v. Comm.*, 54 T.C. 742 (1970), *aff'd* 445 F.2d 985 (10th Cir. 1971).

Thus, if a partnership had partners in each of the Third, Fifth, Seventh and Ninth Circuits, the valuation misstatement penalty could be applied against those residing in the Third and Seventh Circuits, but not those

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[2] Generally, partnerships are audited by and disputes with the IRS are resolved pursuant to the unified procedures set forth in 26 U.S.C. §§ 6221 *et seq.* But small partnerships, as defined in 26 U.S.C. § 6231(a)(1)(B), are excluded from the unified procedures unless the partnership elects to be included within those procedures.

residing in the Fifth and the Ninth Circuits. This anomalous result occurs because of the courts' divergent approaches regarding whether, for purposes of 26 U.S.C. § 6662, an understatement of tax is "attributable to" a valuation misstatement as a consequence of the court's disallowance of a deletion or credit.

CONCLUSION

Consistency among the appellate courts regarding the proper test for determining whether a transaction has economic substance is vital to the proper administration of the tax laws. Consistency is also needed concerning the proper interpretation of 26 U.S.C. § 6662. In the present climate, however, taxpayers face inconsistent rules governing even straightforward transactions. The federal courts are profoundly divided — and the issues have crystallized, presenting an ideal vehicle for this Court's review. For the reasons set forth above, amicus curiae Stobie Creek urges the Court to grant review.

Respectfully submitted,

NEIL LLOYD
SCHIFF HARDIN LLP
6600 Sears Tower
Chicago, IL 60606
(312) 258-5628

ROBERT E. KOLEK
Counsel of Record
SCHIFF HARDIN LLP
6600 Sears Tower
Chicago, IL 60606
(312) 258-5755

Counsel for Amicus Curiae
Stobie Creek Investments, LLC